

WHY DEFICITS MATTER

HEARING BEFORE THE COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES ONE HUNDRED TENTH CONGRESS FIRST SESSION

HEARING HELD IN WASHINGTON, DC, JANUARY 23, 2007

Serial No. 110-2

Printed for the use of the Committee on the Budget



Available on the Internet:
<http://www.gpoaccess.gov/congress/house/budget/index.html>

U.S. GOVERNMENT PRINTING OFFICE

32-738 PDF

WASHINGTON : 2007

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WHY DEFICITS MATTER

TUESDAY, JANUARY 23, 2007

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:07 a.m., in room 210, Cannon House Office Building, Hon. John M. Spratt, Jr. [chairman of the committee] presiding.

Present: Representatives Spratt, DeLauro, Edwards, Cooper, Allen, Doggett, Boyd, McGovern, Sutton, Andrews, Scott, Etheridge, Hooley, Moore, Bishop, Ryan, Bonner, Garrett, Barrett, Diaz-Balart, Hensarling, Lungren, McHenry, Campbell, Porter, Alexander, Smith, and Tiberi.

Chairman SPRATT. I will call the hearing to order and first recognize our witnesses and turn to the ranking member for any statement he wishes to make.

On this day, when we will hear from the President on the State of the Union, I am pleased that we will also hear from our distinguished witnesses on why deficits matter.

I wanted to thank our witnesses for today's hearing: The Comptroller of the United States, who needs no introduction, he has been here plenty of times before and has become a very vocal, visible and responsible advocate for fiscal responsibility, David Walker, head of the Government Accountability Office; Dr. Edward Gramlich, who is the Richard B. Fisher Senior Fellow at the Urban Institute, and Dr. Edwin M. Truman, who is the Senior Fellow at the Peterson Institute For International Economics.

As I have said, the topic for today is a very pressing and pertinent and timely one, and that is, do deficits matter? As we begin this 110th Congress, we find ourselves faced with a daunting task. Six years ago, the budget was in surplus, the surplus by official projections over 10 years to the tune of \$5.6 trillion. Within 2 years, that surplus was gone, vanished, disappeared. Within 2 more years, the deficit reached record levels, over \$400 billion. Fortunately, the deficit has come down a bit from there, but nobody can assume the deficit is on a glide path to being balanced or the budget is on a glide path to being balanced by any means, and nor should anyone assume that the task of bringing it back to balance, putting the budget back in surplus is going to be an easy one. It will not be.

In the 1980s and 1990s, we had four different major efforts on the budget: Gramm, Rudman and Hollings, the Bush Budget Summit in 1990, 1991, the Clinton budget in 1993, and the Balanced

Budget Act of 1997. It took us all of those budgets to finally bring the budget to heel and put it back in surplus.

So today we will explore with our witnesses do deficits matter. Is this something that should be an urgent priority for this Congress or is this something that we can put on the back burner while we attend to other priorities? If they do matter, to what extent are they a problem and what should we do about the problem?

Those are, broadly speaking, the questions we put to our witnesses today; and before turning first to General Walker, I want to turn to our ranking member, Mr. Ryan, for any statement he cares to make.

Mr. RYAN. I thank the chairman for yielding. I would like to make a few opening remarks.

Number one, I think both members, Republicans and Democrats here, share concern about the effects of chronic deficit spending. But it is not enough for us to just sit here and rail against deficits. We have got to understand the cause of today's deficits; and we have got to recognize that deficits are a symptom, a symptom of excessive spending that is going to get dramatically worse if we don't take the right steps to control it.

First, let's review how we got to this point. I have no doubt that we are going to hear later on today that Republicans squandered a \$5.6 trillion surplus through reckless tax cuts and spending. We are going to hear this a lot in the next couple of years, I think, but it is important to note that the surplus was a projection, was a guess into the future, one that did not foresee the bursting of the dot-com bubble, economic slowdown and the recession of 2000 and 2001, attacks on 9/11 and the ensuing war on terror.

Tax relief was not the problem. Well-timed tax relief not only helped buoy the economy out of recession, it also unlocked investment, leading to significant job creation, sustained economic growth we have seen over the past few years. That economic growth results in the key factor in recent deficit reduction. In fact, despite an immense set of costly challenges, from the war on terror to last year's hurricanes, we have had significant progress in reducing short-term deficits through pro-growth economic policies and spending restraint.

Last year, the deficit fell to \$248 billion, a drop of \$114 billion since January estimates and the lowest deficit in 4 years. The current deficit is 2 percent of GDP. That is well below the average of the past 35 years and is projected to stay in that range to the end of the decade under current policies.

Again, the primary reason for this improvement is double-digit growth in revenues coming into the Federal Treasury. I wish we did a lot more on spending, but we have plenty of revenues coming into the Federal Government. Even with accelerated tax relief that we have had, revenues for 2006 reached 18.4 percent of GDP and that is higher than the average of the past four decades; and, recently, both CBO and the Treasury reported the revenue for the first quarter of the fiscal year 2007 was 8.1 percent ahead of the prior year.

On appropriations, over the past 3 years, we held nonsecurity appropriations to less than inflation, higher than I would have done it, but we held some limit on that.

Entitlements, in 2005, for the first time in about a decade, we took the first step toward reining in the largest, least sustainable portion of our Federal Government, entitlement spending, by saving \$40 billion over the next 5 years.

But while the near-term fiscal outlook is improving, the oncoming retirement of the baby boomers—and the first of them just turned 60 last year—will bring rapidly swelling demands in the budget and in the economy.

As this committee has been told time and again by experts ranging from our witness today, Dave Walker, to Doug Holtz-Eakin at CBO to Alan Greenspan, the chief threat to our Nation's long-term fiscal health is spending, particularly the unsustainable growth rates in our Nation's big three entitlement programs: Social Security, Medicare and Medicaid. These three programs right now consume about 9 percent of our economy, 9 percent of GDP. They are going to grow to about 15.5 percent of GDP by 2030. Without fundamental structural reforms, neither the budget nor the economy can sustain projected spending for these programs as they are currently structured.

I just want to close with one quote from our esteemed witness, General Walker, who said in an earlier hearing, "We cannot grow our way out of this problem." Eliminating earmarks will not solve the problem; lightening up fraud, waste and abuse will not solve the problem; ending the war or cutting way back on defense will not solve the problem; and letting the recent tax cuts expire will not solve the problem. We are going to have to do much bigger things in Congress. We are going to have to have much larger reforms, and all roads lead to fundamental restructuring of these entitlement programs if we are going to solve the problem.

Do we want to give our kids and our grandkids a government that is literally twice the size of the government we have today, that we would literally have to tax about 40 percent of our Nation's output in order to just pay for the programs that we have today in the future? I don't think we want to do that, Mr. Chairman; and I appreciate the chance to have this conversation, this dialogue. We have great witnesses today, and I look forward to it.

Thank you.

Chairman SPRATT. Let me remind the gentleman that over the last 6 years we have accumulated \$3.1 trillion in debt, statutory debt. The debt service on that debt will be with us for years to come, and that debt service widening—the widening wage in the budget is going to make it even harder than ever to resolve the entitlements problems. Because if there is one entitlement truly entitled mandatory spending it is interest on the national debt. We can change the other programs, but interest on the national debt is obligatory. And as it grows and grows and grows, it crowds out our ability to respond to other demands and promises we have made and keep those promises.

But we didn't come here to talk ourselves. We have come here to hear what you have to say, General Walker, and what our other two witnesses have. The floor is yours. We will make your statement a part of the record if you care to summarize it. The chart is on the wall, the screens on the wall are yours, too, because I am sure you have come armed with charts.

Before I proceed, let me ask unanimous consent that all members be allowed to put their opening statement, if they care to file one, in the record at this point.

General Walker, the floor is yours.

**STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL
OF THE UNITED STATES**

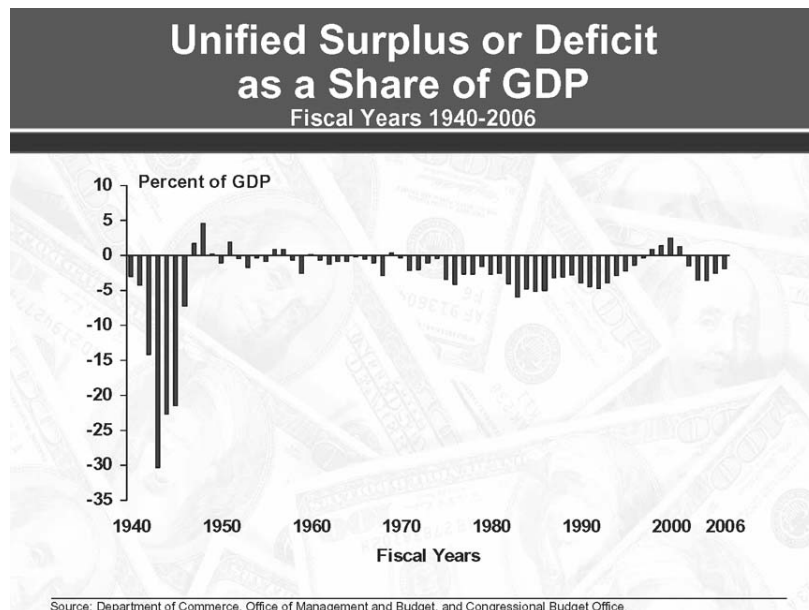
Mr. WALKER. Thank you Chairman Spratt, Ranking Member Ryan, members of the House Budget Committee. It is a pleasure to be back before you today to talk about why deficits matter.

I do have a PowerPoint presentation which I am going to use. I find that when you are dealing with numbers this big, you need to have charts and graphs or else you really can't convey the message effectively. You have a copy of my full statement which I have also provided for the record.

Let me first answer the question, do deficits matter? The answer is, if you care about—pardon me—if you are concerned with stewardship and if you care about the future of our country, our children and our grandchildren, the answer is a clear yes, they do matter.

Secondly, today in America we suffer from two maladies: near-sightedness or shortsightedness and tunnel vision. The analogy from a fiscal standpoint is, the short-term deficits aren't our problem. It is where we are headed, and where we are headed could swamp the ship of state if we don't get serious soon. The simple truth is, we do not face an immediate heart attack, but we have been diagnosed with cancer, and we need to change behavior, and we need to engage in dramatic and fundamental reforms, which I will touch on, in order to save our future.

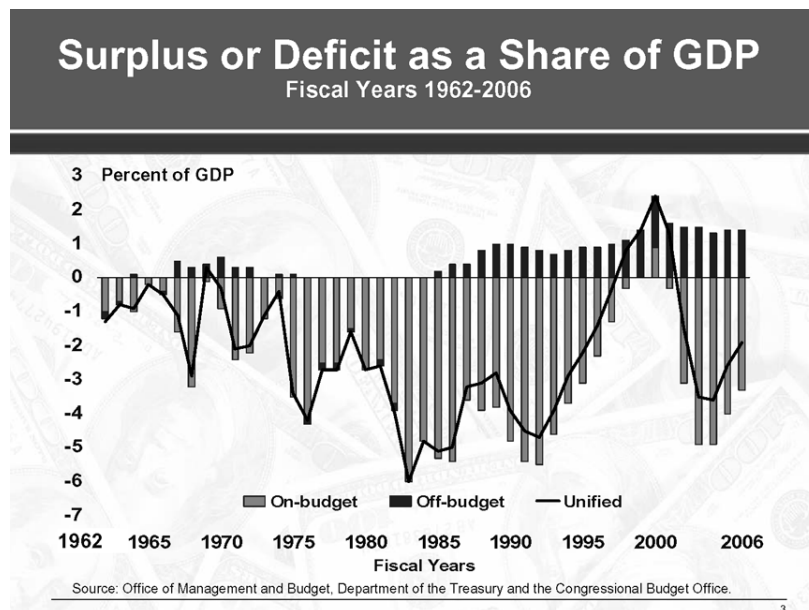
First slide, please.



This represents deficits as a percentage of the economy, going back to World War II.

A couple of comments. First, obviously, our country and our way of life was threatened in World War II. We did what it took and subsequently were able to pay off most of that debt for a variety of reasons.

In the 1980s, we did have larger deficits as a percentage of the GDP than we do today, but we got something for it. We bankrupted the Soviet Union, we won the Cold War, and we declared a peace dividend. Only time will tell what we get for the current deficits. Next, please.



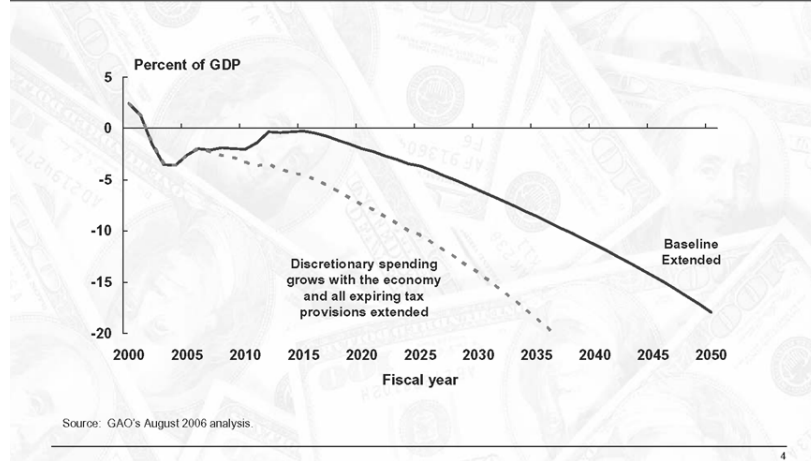
This represents deficits as a percentage of the economy for more recent years, since 1962. The red represents the on-budget deficit. The blue represents the off-budget surplus, primarily Social Security. The black line represents the unified deficit, and I think you can see here that we did run larger deficits as a percentage of the economy in the 1980s.

We then took a number of dramatic steps. We turned deficits into surpluses. The trend turned negative. It has gotten better in the last several years, but let me reinforce my statement: The problem is not the short term. The problem is the long run.

We should not be having a debate in my opinion, in my professional opinion, about whether or not deficits were larger in the 1980s. The fact is, when you are flying a plane, driving a car, you need to look forward, not in the rear-view mirror, and it doesn't really make a difference what the deficits were in the 1980s. What matters is where we are now and where are we headed and what the consequences to the country and our children and grandchildren.

Next, please.

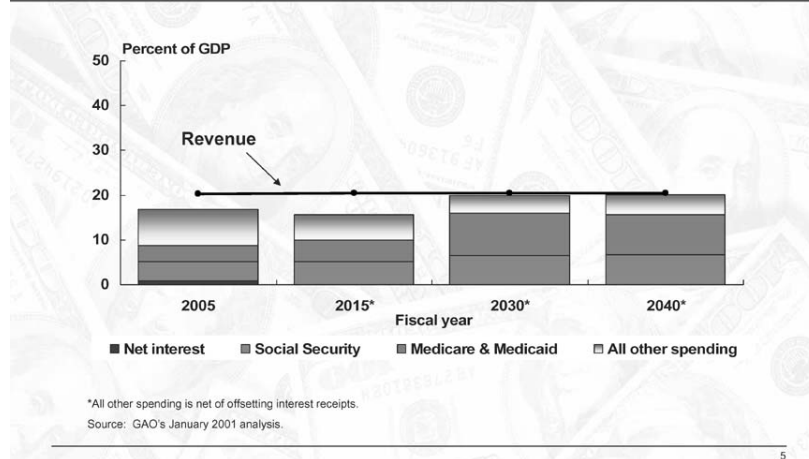
Unified Surpluses and Deficits as a Share of GDP under Alternative Fiscal Policy Simulations



This represents the future of unified surpluses and deficits as a share of GDP under two alternative fiscal policy simulations. One is CBO baseline extended. You can see, even with that, we face large problems in the years that grow.

The second one, which is the red dotted line, shows discretionary spending growing with the economy and all tax provisions that are scheduled to expire being extended. Neither way sustainable. We are going to have to engage in dramatic and fundamental reforms. Next, please.

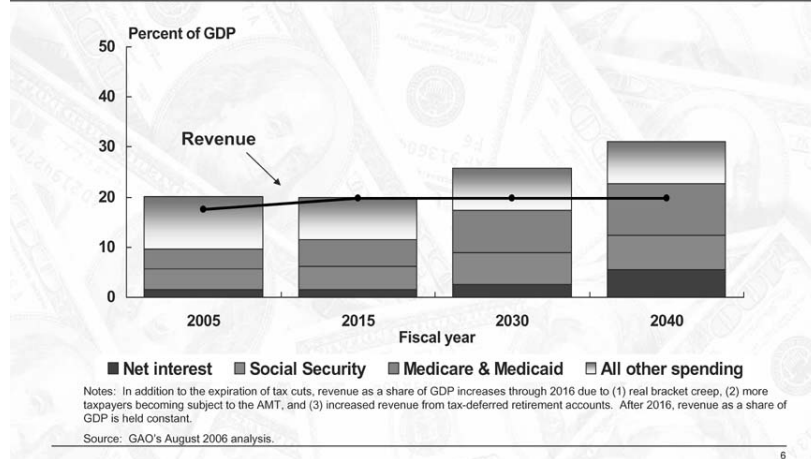
Composition of Spending as a Share of GDP Under Baseline Extended (January 2001)



In January and February of 2001, I testified before numerous committees in the House and the Senate about where we stood from a financial and fiscal standpoint. This represented GAO's long-range fiscal simulation in January of 2001. It was based upon a number of assumptions, some of which proved to be valid, some of which did not. Anytime you go out 40-plus years, that is a long way to go; and, obviously, the power of compounding is such that the further out you go the more variance there can be. The bottom line is, based upon this, we had fiscal sustainability for 40-plus years; and, at that time, we were even on a path to pay down all of the national debt, although I know a lot of people were really concerned about that. Personally, I was never really concerned about that, but some people were.

Next, please.

Composition of Spending as a Share of GDP Under Baseline Extended (August 2006)



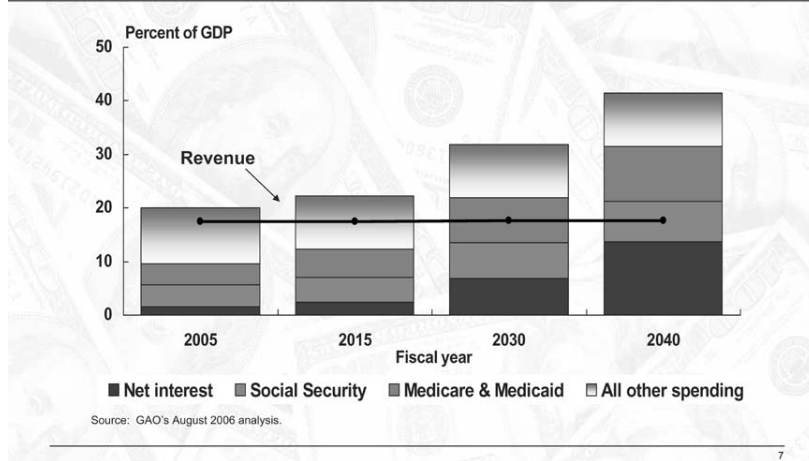
When it comes up, you will see the next one represents the current simulation based upon CBO's baseline extended. That represents the current simulation based upon CBO's baseline extended; and, just to help, the black line represents revenues as a percentage of the economy, only Federal revenues. The bars represent spending as a percentage of the economy. So inflation is taken out of these numbers.

When the bar is above the line, that is a deficit. And you can see that even under, you know, baseline extended, which assumes that all tax cuts will expire, which assumes that discretionary spending will only grow by the rate of the economy for the first 10 years and assumes a number of other things, including that we don't have a long-term fixed AMT, you can see we have a large and growing problem in the outyears.

Next, please.

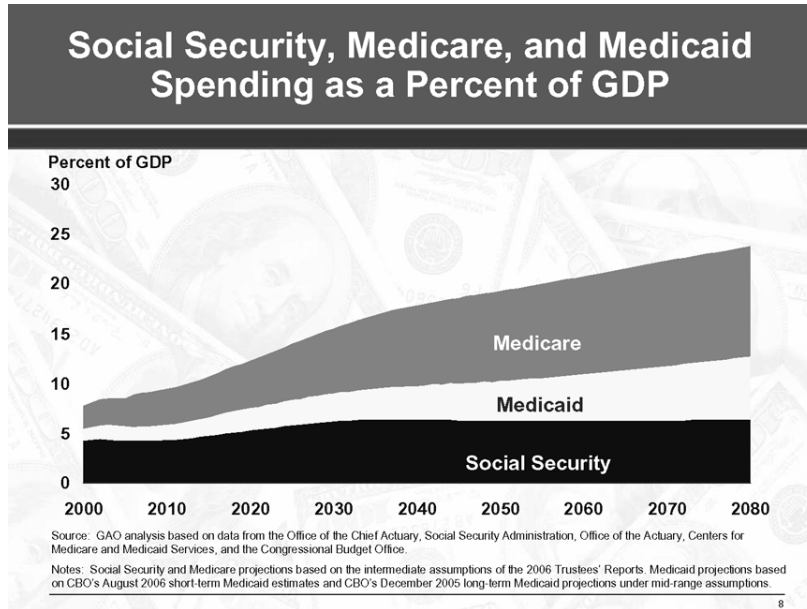
Composition of Spending as a Share of GDP

Assuming Discretionary Spending Grows with GDP After 2006
and All Expiring Tax Provisions are Extended



The following simulation assumes that discretionary spending grows by the rate of the economy, rather than the rate of inflation, and that the expiring tax cuts are made permanent and that somehow we do something with AMT such that we are basically maintaining about the historical level of taxation as compared to the economy. Well, on this, you can see that the fastest-growing cost by far is the bottom blue segment, which represents interest on the Federal debt. Now, unlike 2001, where we had fiscal sustainability for 40-plus years, under this, the model blows up in the 2040s.

Next, please.



We are on a path where, even if you exclude interest on the Federal debt, which, obviously, you can't, the Federal Government is not going to default either on debt held by the public or, frankly, debt held by the trust funds. We are not going to default on that. We will deliver on that. It represents a priority claim on future general revenues.

But if you exclude interest on the debt, which, obviously, we can't, but for lesser purposes Social Security, Medicare and Medicaid alone are on a path, well, they will consume the entire revenues based on a historical percentage of our economy, these three programs alone. That obviously can't be allowed to happen.

Next, please.

Major Reported Long-Term Fiscal Exposures (\$ trillions)

	2000	2006	% Increase
• Explicit liabilities	\$6.9	\$10.4	52
• Publicly held debt			
• Military & civilian pensions & retiree health			
• Other			
• Commitments & contingencies	0.5	1.3	140
• E.g., PBGC, undelivered orders			
• Implicit exposures	13.0	38.8	197
• Future Social Security benefits	3.8	6.4	
• Future Medicare Part A benefits	2.7	11.3	
• Future Medicare Part B benefits	6.5	13.1	
• Future Medicare Part D benefits	--	7.9	
Total	\$20.4	\$50.5	147

Source: 2000 and 2006 Financial Report of the United States Government.

Note: Estimates for Social Security and Medicare are at present value as of January 1 of each year and all other data are as of September 30. Totals may not add due to rounding. Percentage increases are based on actual data and may differ from increases calculated from rounded data shown in table.

Now, this is important. In the last 6 years, the total liabilities and unfunded commitments of the United States government have gone up from \$20 trillion—now you have to write 12 zeros to the right of that 20; it is really not impressive until you write it out—\$20 trillion to \$50 trillion in 6 years, primarily due to Medicare. The Medicare prescription drug benefit alone comes with an \$8 trillion price tag. That \$8 trillion price tag is more than the entire unfunded obligation of Social Security.

Mr. SCOTT. Present value?

Mr. WALKER. Present value.

Let me help explain this. This takes dedicated payroll tax and premium revenues over the next 75 years, estimated benefit payments based upon the best estimate assumptions of the trustees of Social Security and Medicare—and I used to be one from 1990 to 1995. You calculate the difference, and you discount it back to current dollar terms at Treasury rates.

So, in other words, how much money would you have to have today invested at Treasury rates in order to deliver on the promise with no reforms? This is how much money you would have to have. It has gone up almost—well, it has gone up 147 percent in 6 years.

Now the next one I think is easier to understand.

Understanding the Size of Major Reported Fiscal Exposures

Our fiscal burden can be translated and compared as follows:

	2006
Major reported fiscal exposures	\$50.5 trillion
Total household net worth	\$53.3 trillion
Ratio of fiscal exposures to net worth	95 percent
Burden	
Per person	\$170,000
Per full-time worker	\$400,000
Per household	\$440,000
Income	
Median household income	\$46,326
Disposable personal income per capita	\$31,519
Ratio of household burden to median income	9.5

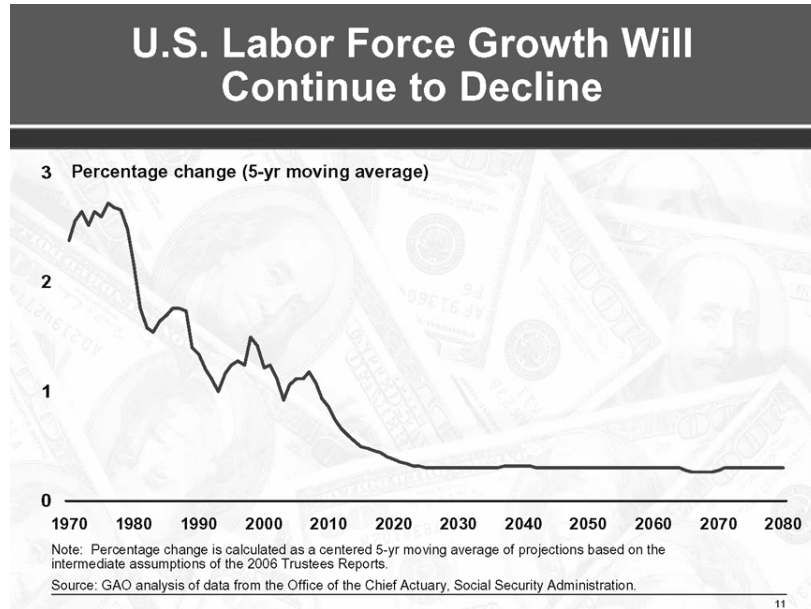
Sources: GAO analysis of data from the Department of the Treasury, Federal Reserve Board, U.S. Census Bureau and Bureau of Economic Analysis

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How can we take \$50 trillion and translate that into terms that you and I and, you know, people on Main Street can understand? First, \$50 trillion is 95 percent of the entire net worth of every American. \$50 trillion is 95 percent of the estimated net worth of every American, individual net worth, doesn't count corporate retained earnings.

By the way, it was below—that percentage was below 50 percent 6 years ago. Last year, the percentage was 91 percent. We are on a path to where it will exceed 100 percent within the next 2 years.

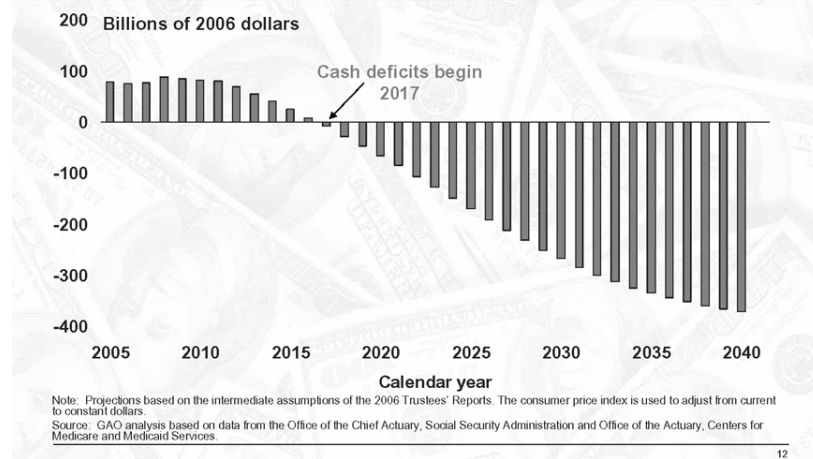
\$50 trillion is \$440,000 per American household. Median household income in America is less than \$47,000. So, stated differently, the typical American household has an implicit debt of over nine times our annual income. That is like having a mortgage but no house. And while this obligation will end up having to be discharged over a number of years, the only asset that people have to discharge this obligation is their citizenship in the United States of America, which does provide unparalleled opportunities, but it obviously is not a tangible asset.



The next chart shows that part of our problem is that, in addition to the fiscal issue, we face slowing labor force growth. We have an aging society with longer life spans; people are wanting to retire earlier. That undercuts our ability to continue to grow economically, especially in a knowledge-based economy where it is brain power rather than brawn power that drives value and where people have an ability and hopefully an opportunity to work longer and to continue to contribute to our economy, both from the standpoint of the revenue side and to reduce the expenditure side over time.

Next, please.

Projected Cash Surpluses and Deficits in the Combined Social Security Trust Fund



Cash is key. This represents cash flows for the Social Security Trust Fund. The Social Security Trust Fund will start declining in its surpluses in 2009. Congress will therefore start going through withdrawal, because Congress has been accustomed and so has the executive branch to being able to spend those surpluses. So, starting in 2009, they will start to decline. In 2017, they will be G-O-N-E, gone. There will be deficits, and we will start having to count on these bonds and trust funds which aren't really trust funds, but that is a different story. We are already running a negative cash flow in Medicare; and, in fact, the Medicare Part A Trust Fund is expected to become exhausted in about 2017, 2018.

Next, please.

The Way Forward: A Three-Pronged Approach

1. Improve Financial Reporting, Public Education, and Performance Metrics
2. Strengthen Budget and Legislative Processes and Controls
3. Fundamental Reexamination & Transformation for the 21st Century (i.e., entitlement programs, other spending, and tax policy)

*Solutions Require Active Involvement from
both the Executive and Legislative Branches*

13

This is a possible way forward. Number one, we have to improve financial reporting, public education and performance metrics. You can't solve a problem until people understand that we have a problem that needs to be solved and it is prudent to solve it sooner rather than later. We need to improve our transparency with regard to financial reporting, budgeting and other legislative processes, more truth in advertising about where we really are.

Secondly, we need to strengthen budget and legislative processes and controls. I am happy to answer questions. We need to bring back the controls that we had in the 1990s, and we need more than we had in the 1990s because we are in worse shape than we were in the early 1990s, and the demographic tsunami of entitlement spending is very close to becoming a reality.

The first baby boomer reaches 62 January 1, 2008, less than a year from now, will be eligible for early retirement under Social Security. They will reach 65 in 2011, will be eligible for Medicare. That will begin a surge in spending which could swamp the ship of state.

And last but certainly not least, and I think Mr. Ryan touched on some of this, most of the Federal Government's policies, programs, functions and activities, whether it is on the tax side, whether it is on the spending side, whether it is on the organizational structure and management models, are based on the 1940s to the 1970s. They get into the base, they are assumed to be okay and, in many cases, they are not effective, and they are outdated. And even if they are reasonably effective and not outdated, they may not be as high a priority for the 21st century as they were when they were put in place.

We have got to engage in a fundamental reexamination and transformation of the entire Federal Government, entitlement pro-

grams, spending policies and tax reform. Also, our organizational models.

We published a document in February, 2005. Every Member of Congress received one. It is entitled, Reexamining the Base—pardon me. It is entitled 21st Century Challenges: Reexamining the Base of the Federal Government. It gives you an idea of the kinds of questions we will have to ask and answer. It will take us 20-plus years, but we need to get started now.

Last two slides.



This is not just about numbers. This is about values and people. The value that I would give you to focus on is stewardship. Stewardship means that leaders have an obligation not just to generate positive results today, not just to leave things better off when you leave than when you came, but better positioned for the future. My generation, the baby boom generation, individuals born between 1946 and 1964, are on track to be the first generation in the history of this country not to discharge its stewardship responsibilities. That is not acceptable to me, and I would imagine it is not acceptable to you. So it is about values, and it is about people.

Next and last.

Why this Matters to Me: The Walker Grandchildren



Christi



Grace



Daniel

These are my three grandchildren. They did not create this problem. This is their problem. They will pay the price. They will bear the burden if tough choices are not made and not made soon. They, obviously, are too young to vote. They have voices, but their voices typically are not heard. I am their voice.

Thank you, Mr. Chairman.

Chairman SPRATT. Thank you very much, General Walker.

[The prepared statement of David Walker follows:]

PREPARED STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES

Chairman Spratt, Mr. Ryan, Members of the Committee: I appreciate this invitation to talk with you about why deficits matter—about our nation's long-term fiscal outlook and the challenge it presents. Your decision to focus on this issue is an important statement about the seriousness with which you view this challenge and your commitment to begin to address it.

You all have entitled this hearing “Why Deficits Matter.” Let me start with a very simple reason: they matter for the world we leave our children and grandchildren. As all of you know—and as I will discuss in this statement—it is not the short-term deficit that threatens us; it is the longterm fiscal outlook. We are on an imprudent and unsustainable path. Continuing on our current fiscal path would gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately even our domestic tranquility and our national security. This is a great nation with much to be proud of and much to be thankful for. But today we are failing in one of our most important stewardship responsibilities—our duty to pass on a country better positioned to deal with the challenges of the future than the one we were given.

The picture I will lay out for you today is not a pretty one and it's getting worse with the passage of time. But this nation has met difficult challenges—including challenges to its very existence—in the past and I'm confident that we can do so again.

The essence of my message today is no surprise to Members of this Committee:

- Our current financial condition is worse than is widely understood.
- Our current fiscal path is both imprudent and unsustainable.
- Improvements in information and processes are needed and can help.
- Meeting our long-term fiscal challenge will require (1) significant entitlement reform to change the path of those programs; (2) reprioritizing, restructuring and constraining other spending programs; and (3) more revenues—hopefully through a reformed tax system. This will take bipartisan cooperation and compromise.

- The time to act to save our future is now!

When fiscal year 2006 ended a great deal of attention was paid to the fact that at \$248 billion “the deficit” came in lower than originally predicted and lower than in 2005. And just this week press reports have noted that—as figure 1 shows—the (unified) deficit as a share of the economy is not terribly high.

This is all true—and it is also misleading. First, a single year’s unified budget deficit is not the critical issue here. Certainly this improvement in the 1-year fiscal picture is better than a worsening in that picture, but it did not fundamentally change our long-term fiscal outlook. In fact, the U.S. government’s total reported liabilities, net social insurance commitments, and other fiscal exposures continue to grow and now total approximately \$50 trillion, representing approximately four times the nation’s total output, or gross domestic product (GDP) in fiscal year 2006, up from about \$20 trillion, or two times GDP in fiscal year 2000.

Further, the long-term challenge is fast becoming a short-term one as the first of the baby boomers become eligible for early retirement under Social Security on January 1, 2008—less than one year—and for Medicare benefits in 2011—less than 4 years from now. The budget and economic implications of the baby boom generation’s retirement have already become a factor in the Congressional Budget Office’s (CBO) 10-year baseline projections and will only intensify as the baby boomers age. Simply put, our nation is on an imprudent and unsustainable fiscal path. Herbert Stein once said that something that is not sustainable will stop. That, however, should not give us comfort. It is more prudent to change the path than to wait until a crisis occurs.

And that brings me to my next point. While restraint in the near term and efforts to balance the budget over the next 5 years can be positive, it is important that actions to achieve this also address the long-term fiscal outlook. The real problem is not the near-term deficit—it is the long-term fiscal outlook. It is important to look beyond year 5 or even year 10. Both the budget and the budget process need more transparency about and focus on the long-term implications of current and proposed spending and tax policies. In this testimony I will suggest a number of things that I believe will help in this area.

OUR FISCAL AND FINANCIAL CONDITION IS WORSE THAN WIDELY UNDERSTOOD

A great deal of budget reporting focuses on a single number—the unified budget deficit, which was \$248 billion in fiscal year 2006. This largely cash-based number represents the difference between revenues and outlays for the government as a whole. It is an important measure since it is indicative of the government’s draw on today’s credit markets—and its claim on today’s economy. But it also masks the difference between Social Security’s cash flows and those for the rest of the budget. Therefore we also need to look beneath the unified deficit at the on-budget deficit—what I like to call the “operating deficit.” And, finally, we should be looking at the financial statements’ report of net operating cost—the accrual-based deficit.

Social Security currently takes in more tax revenue than it needs to pay benefits. This cash surplus is invested in Treasury securities and earns interest in the form of additional securities. The difference between the on-budget deficit and the unified budget deficit is the total surplus in Social Security (cash and interest) and the U.S. Postal Service. Excluding consideration of the \$185 billion surplus in Social Security and a \$1 billion surplus in the Postal Service, the on-budget deficit was \$434 billion in 2006. Figure 2 shows graphically how the on-budget deficit and the offbudget surplus have related and combine to lead to the unified deficit. Since the Social Security trust fund invests any receipts not needed to pay benefits in Treasury securities, its cash surplus reduces the amount the Treasury must borrow from the public. As I will note later, this pattern of cash flows is important—and it is projected to come to an end just 10 years from now.

The third number, net operating cost, is the amount by which costs exceed revenue and it is reported in the federal government’s financial statements, which are prepared using generally accepted accounting principles.¹ Costs are recorded on an accrual basis—namely, in the period when goods are used or services are performed as opposed to when the resulting cash payments are made. However, most revenues, on the other hand, are recorded on the modified cash basis—that is, they are recorded when collected. The net operating cost can be thought of as the accrual deficit. The accrual measure primarily provides more information on the longer-term implications of today’s policy decisions and operations by showing certain costs incurred today but not payable for years to come, such as civilian and military pensions and retiree health care. In fiscal year 2006 net operating cost was \$450 billion.

All three of these numbers are informative. However, neither accrual nor cash measures alone provide a full picture of the government’s fiscal condition or the cost of government. Used together, they present complementary information and provide

a more comprehensive picture of the government's financial condition today and fiscal position over time. For example, the unified budget deficit provides information on borrowing needs and current cash flow. The accrual deficit provides information on the current cost of government, but it does not provide information on how much the government has to borrow in the current year to finance government activities. Also, while accrual deficits provide more information on the longer-term consequences of current government activities, they do not include the longer-term cost associated with social insurance programs like Social Security and Medicare. In addition, they are not designed to provide information about the timing of payments and receipts, which can be very important. Therefore, just as investors need income statements, statements of cash flow, and balance sheets to understand a business's financial condition, both cash and accrual measures are important for understanding the government's financial condition.²

Although looking at both the cash and accrual measures provides a more complete picture of the government's fiscal stance today and over time than looking at either alone, even these together do not tell us the full story. For example, as shown in table 1, all three of these deficits improved between fiscal year 2005 and fiscal year 2006.³ This improvement, however, did not result from a change in the fundamental drivers of our long-term challenge and did not signal an improvement in that outlook. To understand the long-term implications of our current path requires more than a single year's snapshot. In this regard, the long-term outlook has worsened significantly in the last several years. That is why for more than a decade GAO has been running simulations to tell this longer-term story.

THE CURRENT LONGTERM FISCAL OUTLOOK IS UNACCEPTABLE

As I mentioned, it is not the recent past shown in figure 1—nor the outlook for this year—that should concern us. Rather it is the picture in figure 3 that should worry us.

Long-term fiscal simulations by GAO, CBO, and others all show that we face large and growing structural deficits driven primarily by rising health care costs and known demographic trends. GAO runs simulations under two sets of assumptions. One takes the legislatively-mandated baseline from CBO for the first 10 years and then keeps discretionary spending and revenues constant as a share of GDP while letting Social Security, Medicare, and Medicaid grow as projected by the Trustees and CBO under midrange assumptions.⁴ The other, perhaps more realistic, scenario based on the Administration's announced policy preferences changes only two things in the first 10 years: discretionary spending grows with the economy and all expiring tax provisions are extended.⁵ Like the "Baseline Extended" scenario, after 10 years both revenues and discretionary spending remain constant as a share of the economy. As figure 3 shows, deficits spiral out of control under either scenario. We will be updating these figures with the release of the new CBO baseline later this month, but even with the lower deficit in 2006, the long-term picture will remain daunting.

Looking more closely at each scenario gives a fuller understanding of what the impact of continuing these trends would have on what government does. And it shows us "Why Deficits Matter."

First, it makes sense to look back to 2001—it is worth understanding how much worse the situation has become. As I noted, despite some recent improvements in short-term deficits, the long-term outlook is moving in the wrong direction.

Figures 4 and 5 show the composition of spending under our "Baseline Extended" scenario in 2001 and 2006. Even with short-term surpluses, we had a long-term problem in 2001, but it was more than 40 years out. Certainly an economic slowdown and various decisions driven by the attacks of 9/11 and the need to respond to natural disasters have contributed to the change in outlook. However, these items alone do not account for the dramatic worsening. Tax cuts played a major role, but the single largest contributor to the deterioration of our long-term outlook was the passage of the Medicare prescription drug benefit in 2003.

Figure 5 illustrates today's cold hard truth, that neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance. This is even clearer under the more realistic scenario as shown in figure 6. Estimated growth in the major entitlement programs results in an unsustainable fiscal future regardless of whether one assumes future revenue will be somewhat above historical levels as a share of the economy as in the first simulation (fig. 5) or lower as shown in figure 6.

Both these simulations remind us "Why Deficits Matter." They illustrate that without policy changes on the spending and revenue side of the budget, the growth in spending on federal retirement and health entitlements will encumber an esca-

lating share of the government's resources. A government that in our children's lifetimes does nothing more than pay interest on its debt and mail checks to retirees and some of their health providers is unacceptable.

Although Social Security is a major part of the fiscal challenge, contrary to popular perception, it is far from our biggest challenge. While today Social Security spending exceeds federal spending for Medicare and Medicaid, that will change. Over the past several decades, health care spending on average has grown much faster than the economy, absorbing increasing shares of the nation's resources, and this rapid growth is projected to continue. CBO estimates that Medicare and Medicaid spending will reach 6.3 percent of GDP in 2016, up from 4.6 percent this year (2007), while spending for Social Security will only reach 4.7 percent of GDP in 2016 up from 4.2 percent this year. For this reason and others, rising health care costs pose a fiscal challenge not just to the federal budget but also to states, American business, and our society as a whole.

While there is always some uncertainty in long-term projections, two things are certain: the population is aging and the baby boom generation is nearing retirement age. The aging population and rising health care spending will have significant implications not only for the budget but also for the economy as a whole. Figure 7 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2006 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, federal spending for these entitlement programs combined will grow to 15.5 percent of GDP in 2030 from today's 9 percent. This graphic is another illustration of why we have to act. I do not believe we are prepared to have programs that provide income for us in retirement and pay our doctors absorb this much of our children's and grandchildren's economy. It is clear that taken together, Social Security, Medicare, and Medicaid under current law represent an unsustainable burden on future generations.

While Social Security, Medicare, and Medicaid dominate the long-term outlook, they are not the only federal programs or activities that bind the future. Part of what we owe the future is leaving enough flexibility to meet whatever challenges arise. So beyond dealing with the "big 3," we need to look at other policies that limit that flexibility—not to eliminate all of them but to at least be aware of them and make a conscious decision about them. The federal government undertakes a wide range of programs, responsibilities, and activities that obligate it to future spending or create an expectation for spending and potentially limit long-term budget flexibility. GAO has described the range and measurement of such fiscal exposures—from explicit liabilities such as environmental cleanup requirements to the more implicit obligations presented by life-cycle costs of capital acquisition or disaster assistance.

Figure 8 shows that despite improvement in both the fiscal year 2006 reported net operating cost and the cash-based budget deficit, the U.S. government's major reported liabilities, social insurance commitments, and other fiscal exposures continue to grow. They now total approximately \$50 trillion—about four times the nation's total output (GDP) in fiscal year 2006—up from about \$20 trillion, or two times GDP in fiscal year 2000.

Clearly, despite recent progress on our short-term deficits, we have been moving in the wrong direction in connection with our long-range imbalance in recent years. Our long-range imbalance is growing daily due to continuing deficits, known demographic trends, rising health care costs, and compounding interest expense.

We all know that it is hard to make sense of what "trillions" means. Figure 9 provides some ways to think about these numbers: if we wanted to put aside today enough to cover these promises, it would take \$170,000 for each and every American or approximately \$440,000 per American household. Considering that median household income is about \$46,000, the household burden is about 9.5 times median income.

PROCESS AND PRESENTATIONAL CHANGES TO INCREASE TRANSPARENCY AND FOCUS ON LONG-TERM CONSEQUENCES CAN HELP

Since at its heart the budget challenge is a debate about the allocation of limited resources, the budget process can and should play a key role in helping to address our long-term fiscal challenge and the broader challenge of modernizing government for the 21st century. I have said that Washington suffers from myopia and tunnel vision. This can be especially true in the budget debate in which we focus on one program at a time and the deficit for a single year or possibly the costs over 5 years without asking about the bigger picture and whether the long term is getting better or worse. We at GAO are in the transparency and accountability business. Therefore it should come as no surprise that I believe we need to increase the understanding

of and focus on the long term in our policy and budget debates. To that end—as I noted earlier—I have been talking with a number of Members of the Senate and the House as well as various groups concerned about this issue concerning a number of steps that might help. I’ve attached a summary of some of these ideas to this statement. Let me highlight several critical elements here.

- The President’s budget proposal should again cover 10 years. This is especially important given that some policies—both spending and tax—cost significantly more (or lose significantly more revenue) in the second 5 years than in the first. In addition, the budget should disclose the impact of major tax or spending proposals on the short, medium, and long term.

- The executive branch should also provide information on fiscal exposures—both spending programs and tax expenditures—that is, the long-term budget costs represented by current individual programs, policies, or activities as well as the total.

- The budget process needs to pay more attention to the long-term implication of the choices being debated. For example, elected representatives should be provided with more explicit information on the long-term costs of any major tax or spending proposal before it is voted upon. It is sobering to recall that during the debate over adding prescription drug coverage to Medicare, a great deal of attention was paid to whether the 10-year cost was over or under \$400 billion. Not widely publicized—and certainly not surfaced in the debate—was that the present value of the long-term cost of this legislation was about \$8 trillion!

Of course, when you are in a hole, the first thing to do is stop digging. I have urged reinstitution of the statutory controls—both meaningful caps on discretionary spending and pay-as-you-go (PAYGO) on both the tax and spending sides of the ledger—that expired in 2002. However given the severity of our current challenge, Congress should look beyond the return to PAYGO and discretionary caps. Mandatory spending cannot remain on autopilot—it will not be enough simply to prevent actions to worsen the outlook. We have suggested that Congress might wish to design “triggers” for mandatory programs—some measure that would prompt action when the spending path increased significantly. In addition, Congress may wish to look at rules to govern the use of “emergency supplementals.” However, as everyone in this committee knows, these steps alone will not solve the problem. That is why building in more consideration of the long-term impact of decisions is necessary.

MEETING THE LONG-TERM FISCAL CHALLENGE REQUIRES ACTION ON THE SPENDING AND TAX SIDES OF THE BUDGET—COOPERATION AND COMPROMISE WILL BE NECESSARY

There is no easy way out of the challenge we face. Economic growth is essential, but we will not be able to simply grow our way out of the problem. The numbers speak loudly: our projected fiscal gap is simply too great. To “grow our way out” of the current long-term fiscal gap would require sustained economic growth far beyond that experienced in U.S. economic history since World War II.

Similarly, those who believe we can solve this problem solely by cutting spending or solely raising taxes are not being realistic. While the appropriate level of revenues will be part of the debate about our fiscal future, making no changes to Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require ever-increasing tax levels—something that seems both inappropriate and implausible. That is why I have said that substantive reform of Social Security and our major health programs remains critical to recapturing our future fiscal flexibility. I believe we must start now to reform these programs.

Although the long-term outlook is driven by Social Security and health care costs, this does not mean the rest of the budget can be exempt from scrutiny. Restructuring and constraint will be necessary beyond the major entitlement programs. This effort offers us the chance to bring our government and its programs in line with 21st century realities.⁶ Many tax expenditures act like entitlement programs, but with even less scrutiny. Other programs and activities were designed for a very different time.

Taken together, entitlement reform and reexamination of other programs and activities could engender a national discussion about what Americans want from their government and how much they are willing to pay for those things.

Finally, given demographic and health care cost trends, the size of the spending cuts necessary to hold revenues at today’s share of GDP seems implausible. It is not realistic to assume we can remain at 18.2 percent of GDP—we will need more revenues. Obviously we want to minimize the tax burden on the American people and we want to remain competitive with other industrial nations—but in the end the numbers have to add up.

As I noted, we need to start with real changes in existing entitlement programs to change the path of those programs. However, reform of the major entitlement

programs alone will not be sufficient. Reprioritization and constraint will be necessary in other spending programs. Finally, we will need more revenues—hopefully through a reformed tax system.

The only way to get this done is through bipartisan cooperation and compromise—involving both the Congress and the White House.

Delay only makes matters worse. GAO's simulations show that if no action is taken, balancing the budget in 2040 could require actions as large as cutting total federal spending by 60 percent or raising federal taxes to two times today's level.

FURTHER DELAY WILL ONLY WORSEN THE OUTLOOK

For many years those of us who talk about the need to put Social Security on a sustainable course and to reform Medicare have talked about the benefits of early action. Acting sooner rather than later can turn compound interest from an enemy to an ally. Acting sooner rather than later permits changes to be phased in more gradually and gives those affected time to adjust to the changes. Delay does not avoid action—it just makes the steps that have to be taken more dramatic and potentially harder.

Unfortunately, it is getting harder to talk about early action—the future is upon us.

Next year members of the baby boom generation start to leave the labor force. Figure 10 shows the impact of demographics on labor force growth.

Reflecting this demographic shift, CBO projects the average annual growth rate of real GDP will decline from 3.1 percent in 2008 to 2.6 percent in the period 2012–2016. This slowing of economic growth will come just as spending on Social Security, Medicare and Medicaid will begin to accelerate—accounting for 56 percent of all federal spending by 2016 compared to 43 percent in 2006.

As I noted earlier, today Social Security's cash surplus helps offset the deficit in the rest of the budget, thus reducing the amount Treasury must borrow from the public and increasing budget flexibility—but this is about to change.

Growth in Social Security spending is expected to increase from an estimated 4.8 percent in 2008 to 6.5 percent in 2016. The result, as shown in figure 11, is that the Social Security surpluses begin a permanent decline in 2009. At that time the rest of the budget will begin to feel the squeeze since the ability of Social Security surpluses to offset deficits in the rest of the budget will begin to shrink. In 2017 Social Security will no longer run a cash surplus and will begin adding to the deficit. That year Social Security will need to redeem the special securities it holds in order to pay benefits. Treasury will honor those claims—the United States has never defaulted. But there is no free money. The funds to redeem those securities will have to come from higher taxes, lower spending on other programs, higher borrowing from the public, or a combination of all three.

I spoke before of how big the changes would have to be if we were to do nothing until 2040. Of course, we won't get to that point—something will force action before then. If we act now, we have more choices and will have more time to phase-in related changes.

CONCLUDING REMARKS

Chairman Spratt, Mr. Ryan, Members of the Committee—in holding this hearing even before the President's Budget is submitted you are signaling the importance of considering any proposal within the context of the longterm fiscal challenge. This kind of leadership will be necessary if progress is to be made.

I have long believed that the American people can accept difficult decisions as long as they understand why such steps are necessary. They need to be given the facts about the fiscal outlook: what it is, what drives it, and what it will take to address it. As most of you know, I have been investing a good deal of time in the Fiscal Wake-Up Tour (FWUT) led by the Concord Coalition. Scholars from both the Brookings Institution and the Heritage Foundation join with me and Concord in laying out the facts and discussing the possible ways forward. In our experience, having these people, with quite different policy views on how to address our long-range imbalance, agree on the nature, scale, and importance of the issue—and on the need to sit down and work together—resonates with the audiences. Although the major participants have been Concord, GAO, Brookings, and Heritage, others include such organizations as the Committee for Economic Development (CED); the American Institute of Certified Public Accountants (AICPA); the Association of Government Accountants (AGA); the National Association of State Auditors, Comptrollers and Treasurers (NASACT); and AARP. The FWUT also has received the active support and involvement of community leaders, local colleges and universities, the media, the business community, and both former and current elected officials. We have

been to 17 cities to-date. The discussion has been broadcast on public television stations in Atlanta and Philadelphia. Earlier this month OMB Director Portman and former Senator Glenn joined us at an event at the John Glenn School of Public Affairs at Ohio State University in Columbus, Ohio.

The specific policy choices made to address this fiscal challenge are the purview of elected officials. The policy debate will reflect differing views of the role of government and differing priorities for our country. What the FWUT can do—and what I will continue to do—is lay out the facts, debunk various myths, and prepare the way for tough choices by elected officials. The American people know—or sense—that there is something wrong; that these deficits are a problem. If they understand that there truly is no magic bullet—if they understand that

- we cannot grow our way out of this problem;
 - eliminating earmarks will not solve the problem;
 - wiping out fraud, waste, and abuse will not solve the problem;
 - ending the war or cutting way back on defense will not solve the problem;
 - restraining discretionary spending will not solve the problem; and
 - letting the recent tax cuts expire will not solve this problem;
- then the American people can engage with you in a discussion about what government should do and how.

People ask me how I think this can happen. I know that some Members believe a carefully structured commission will be necessary to prepare a package while others feel strongly that elected officials should take up the task of developing that package. Whatever the vehicle, success will require the active and open-minded involvement of both parties in and both houses of the Congress and of the President. With that it should be possible to develop a package which accomplishes at least three things: (1) a comprehensive solution to the Social Security imbalance—one that is not preprogrammed to require us to have to come back again, (2) Round I of comprehensive tax reform, and (3) Round I of Health Care Reform.

This is a great nation. We have faced many challenges in the past and we have met them. It is a mistake to underestimate the commitment of the American people to their children and grandchildren; to underestimate their willingness and ability to hear the truth and support the decisions necessary to deal with this challenge. We owe it to our country, to our children and to our grandchildren to address this fiscal imbalance. The world will present them with new challenges—we need not bequeath them this burden too. The time for action is now.

Mr. Chairman, Mr. Ryan, Members of the Committee, let me repeat my appreciation for your commitment and concern in this matter. We at GAO stand ready to assist you in this important endeavor.

APPENDIX I: IDEAS FOR IMPROVING THE TRANSPARENCY OF LONG-TERM COSTS AND THE ATTENTION PAID TO THESE COSTS BEFORE DECISIONS ARE MADE

Supplemental Reporting in the President's Annual Budget Submission

- Produce an annual Statement of Fiscal Exposures, including a concise list and description of exposures, cost estimates where possible, and an assessment of methodologies and data used to produce such cost estimates.
- Increase the transparency of tax expenditures by including them in the annual Fiscal Exposures Statement and, where possible, also showing them along with spending and credit programs in the same policy area.
- Provide information on the impact of major tax or spending proposals on short-term, mid-term, and long-term fiscal exposures and on the path of surplus/deficit and debt as percent of gross domestic product (GDP) over 10-year and longer-term horizons (and assuming no sunset if sunset is part of the proposal).
 - Cover 10 years in the budget.
 - Consider requiring the President to include in his annual budget submission a long-term fiscal goal (e.g., balance, surplus, or deficit as percent of GDP).

Additional Executive Branch Reports

- Prepare and publish a Summary Annual Report or Citizen's Summary that summarizes, in a clear, concise, plain English, and transparent manner, key financial and performance information included in the Consolidated Financial Report.
- Prepare and publish a report on long-range fiscal sustainability every 2 to 4 years.

Additional Cost Information on Proposals before Adoption

- Require improved disclosure—at the time proposals are debated but before they are adopted—of the long-term costs of individual mandatory spending and tax proposals over a certain size and for which costs will ramp up over time.

GAO Reports

- An annual report or reports by GAO including comments on the Consolidated Financial Statement (CFS), results of the latest long-term fiscal simulations, comments on the adequacy of information regarding long-term cost implications of existing and proposed policies in the previous year as well as any other significant financial and fiscal issues.

Other Areas in Which GAO Has Suggested That Congress Might Consider Changing the Budget Treatment

- Use accrual budgeting for the following areas where cash basis obligations do not adequately represent the government's commitment:
 - employee pension programs (pre-Federal Employee Retirement System employees);
 - retiree health programs; and
 - federal insurance programs, such as the Pension Benefit Guaranty Corporation and crop insurance.
- Explore techniques for expanding accrual budgeting to
 - environmental cleanup and
 - social insurance—could consider deferring recognition of social insurance receipts until they are used to make payments in the future (this was suggested in GAO's accrual budgeting report as an idea to explore, possibly with a commission designed to explore budget concepts).

ENDNOTES

¹The Financial Report of the United States Government, 2006 can be found at www.fms.treas.gov/fr/index.html.

²GAO is responsible for auditing the financial statements included in the Financial Report, but we have been unable to express an opinion on them for 10 years because the federal government could not demonstrate the reliability of significant portions of the financial statements, especially in connection with the Department of Defense. Accordingly, amounts taken from the Financial Report may not be reliable.

³The decline in both the cash and accrual deficits in 2006 was primarily driven by an increase in federal revenue by almost 12 percent. In addition, the decline in the accrual deficit relative to the cash deficit was primarily due to a decrease in accrual-based expenses resulting from changes in assumptions that are the basis for actuarial estimates for certain accrued long-term liabilities. For a discussion of how the accrual and cash deficits relate to each other see GAO, *Understanding Similarities and Differences between Accrual and Cash Deficits*, GAO-07-117SP (Washington, D.C.: December 2006) and *Understanding Similarities and Differences between Accrual and Cash Deficits, Update for Fiscal Year 2006*, GAO-07-341SP (Washington, D.C. January 2006).

⁴Social Security and Medicare spending is based on the May 2006 Trustees' intermediate projections. Medicaid spending is based on CBO's December 2005 long-term projections under mid-range assumptions.

⁵Additional information about the GAO model, its assumptions, data, and charts can be found at <http://www.gao.gov/special.pubs/longterm/>.

⁶GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005) and *Suggested Areas for Oversight for the 110th Congress*, GAO-07-235R (Washington, D.C.: Nov. 17, 2006).

Chairman SPRATT. Now I am going to propose something, if it agrees with your schedule. I would like to call the other two witnesses forward and put questions to you as a panel, if that is agreeable with everybody.

Mr. WALKER. That would be fine, Mr. Chairman.

Chairman SPRATT. Dr. Gramlich and Dr. Truman, if you would come forward and take your seats beside General Walker. While you are sitting down, I will introduce you further.

Dr. Gramlich has had a long and distinguished career as an economist. He was a professor at the University of Michigan for much of his career, he served as a governor on the Federal Reserve Board from 1997 to 2005, and he was Acting Director of the Congressional Budget Office from 1986 to 1987.

Dr. Truman is the Senior Fellow at the Peterson Institute for International Economics, has been since 2001. He was the Assistant Secretary for International Affairs and Treasury from 1998 to 2001; and before that for a number of years he directed the Division of International Finance, for more than two decades appar-

ently. We are proud and pleased to have you, and we look forward to your testimony.

Chairman SPRATT. Dr. Gramlich, let's begin with yours, if that is agreeable with you.

**STATEMENT OF EDWARD M. GRAMLICH, RICHARD B. FISHER
SENIOR FELLOW, THE URBAN INSTITUTE**

Mr. GRAMLICH. Thank you, Mr. Chairman and committee members.

I have submitted a statement, and I am just going to briefly summarize it.

Chairman SPRATT. Dr. Gramlich, your statement and Dr. Truman's statement will both be made part of the record, so you can summarize it as you wish.

Mr. GRAMLICH. I am going to just refer to one chart that you see there.

Before I get into my statement, let me say one thing. We were asked to talk about deficits and why they mattered, and much of my testimony involved current deficits and why they mattered. But I would strongly endorse what David Walker has just told you, that the real problem is not so much the short run. Short run has some difficulties, as we will talk about, but the real problem is the long run. And so I am going to start with the short run and talk about some of the issues there, and then I am not going to say much about the long run, because I can't do it any better than David Walker already has, and then talk about the policy issues.

Now, David used the cancer analogy, and I am going to be a little bit less dramatic on this. The analogy I used was—it is borrowed from Charles Schultze, who is a former budget director and Chair of the Council on Economic Advisors. He asked at one time whether budget deficits could be likened to a pussycat, that is not a problem; to a wolf at the door huffing and puffing and threatening to blow the house down; or to termites in the basement.

The pussycat argument is basically that private savers will offset the deficit and make it no problem from a standpoint of national saving, and you can see the chart there. The top line is the national saving rate of the United States, and the bottom line is the budget contribution to that national saving.

And you see particularly in the last 20 years that the two are highly correlated. That is when the budget went into surplus in the late 1990s, national saving went up, but before that it had gone down, and after that it has gone down. In other words, private savers have really not offset the behavior of the Federal budget, and so the deficit is not a pussycat. It does have real economic effect.

The wolf at the door argument hinges on two aspects. One is, it is possible that the Fed would in effect—use an economist word here—monetize the deficits and let inflation get out of control. Well, the Fed doesn't have to do that. There are ways to conduct monetary policy without doing that, and the Fed has been very firm in its resolve the past few decades to keep prices stable. It has done that. It can continue to do that. So I don't think that is a realistic worry. It could be in some countries, but not here, not in the United States.

The other part of the wolf argument is that bondholders would begin charging higher interest rates on long-term interest rates on this debt, and that really hasn't happened either. That is one of the things that we used to worry about at the Fed, exactly why long-term interest rates were so low. Chairman Greenspan at one point called it a conundrum. This sent many bond traders to their dictionaries to find out what a conundrum was; and, once they found out, yeah, they agreed, yeah, it is a conundrum that long-term interest rates have not gone up. I will come back to that in a second.

The argument I find most convincing, and it corresponds with David's message here, is that the termites in the basement argument, that you can see from the chart that if we have deficits they really do lower national saving. When national saving goes down, one of two things must happen—this is mathematics—either domestic investment would go down, and I think most of you would agree, that would be a bad thing. That would weaken the country's economy in the long run. Or we borrow the difference. Investment stays up, but our saving has gone down, and so we have to come up with the fund somewhere, so we borrow it from abroad.

This is what Mr. Truman is going to talk about, and I am just going to raise three questions about it. I won't go into that in great detail.

One question you want to ask is, while we have been able to borrow the difference between investment and saving, for how long? How long can we do this? These are international lenders, and they may get cold feet at some point, and then if we can't keep on borrowing, then our investment will have to go down.

The second question that you could ask—and, again, Dr. Truman will address this—is what happens if this borrowing unwinds? You could have—the history of international finance has been that, very often, these periods are ugly, that currency rates change abruptly in a short period of time, and that causes lots of dislocation, and that is an issue, too.

And the third question I would ask is, why do we put ourselves in this position? All we have to do is run responsible fiscal policy. We can keep our national saving at a higher rate, we don't have this decline that we see there recently, and isn't that a more stable and sensible and sound way to manage our economy.

So my fundamental argument about deficits in the short run would be that we are just—this is not good risk management. We are just putting the economy of the country at risk in a way that we don't have to do.

Now, things get much worse in the long run, and you have already seen David Walker's charts and so forth, and you know it is driven by entitlement spending, the demographics. I would just make one further point about that.

Right now, we have roughly 3.3 workers per retiree; and by 2030 we are going to have two workers per retiree. How are these workers in 2030—and these are our kids and grandkids—going to support us if we are still lucky enough to be alive in 2030? Well, they are going to need more capital. That is the way they are going to support us. And the only way they get more capital is by saving more; and so this is a very bad time, I would put, for national saving to drop as it has.

The last point, one simple thing, I am going to try to be non-political about this. Should we fix the deficit on the tax or expenditure side? In the long run, it is obvious. We really have to do something about the growth of entitlement spending. In the short run, I would say it is not so obvious. We could fix it on either side, and I know it is a huge political issue for all of you, but I would just make the simple point as an economist that the problem here is the deficits. These are what ought to be fixed.

If your belief is that America needs lower tax rates, fine, great, congratulations, but you have to cut spending. If your belief is that in some areas America needs more spending, fine, great, congratulations, but you have to be willing to pay the taxes to cover that spending.

Thank you, Mr. Chairman.

Chairman SPRATT. Thank you, Dr. Gramlich.

[The prepared statement of Edward M. Gramlich follows:]

PREPARED STATEMENT OF EDWARD M. GRAMLICH, RICHARD B. FISHER SENIOR
FELLOW, THE URBAN INSTITUTE

Thank you, Mr. Chairman and committee members, for soliciting my testimony on the federal budget deficit problem. It is indeed a problem, as I will try to argue.

Arguments about budget deficits have gotten into the political domain, and it is probably no surprise that controversy has grown up about deficits—just how bad are they? To try to illustrate the exact nature of the problem, I will paraphrase Charles Schultze, the Brookings scholar and former budget director. Some years ago Schultze asked whether deficits could be likened to a pussycat, a wolf at the door (huffing and puffing to blow the house down), or to termites in the basement. Answering this question is critical in knowing whether deficits are a problem and why.

The pussycat argument holds that deficits are not a problem because private savers offset them. As deficits rise, the argument goes, perceptive citizens foresee that future tax payments will be higher, or transfer payments less, and will save more to cover their future costs. This view can be contradicted by personal experience—how many families do each of you know who save more when federal deficits rise? But if this reasoning is not convincing, refer to the attached chart, which compares the BEA concept of national saving with federal budget surpluses (+) or deficits (-). Over nearly a fifty-year period the two track very well. This indicates that as federal deficits rise, private saving changes little, and national saving falls. In other words, private saving does not offset the deficits.

The argument for the wolf at the door, huffing and puffing to blow the house down, takes almost a completely opposite position. This time the argument is that high federal deficits will either put pressure on the Fed to create money to finance the deficits, hence causing inflation, or worry lenders into charging higher interest rates to finance the deficits. The US has run large deficits for some years and neither has happened. For nearly three decades the Federal Reserve has been determined to keep inflation low and stable, it has been perfectly free to do that (financing as much of the deficit as it deems wise), and it has done just that. Deficits have come and gone, but the Fed has been able to keep inflation on track.

As for bondholders, there has been speculation that they would insist on higher long-term bond rates as deficits rose, but this really hasn't happened either. Long-term rates are well-behaved right now—indeed, former Fed Chairman Greenspan referred to their low levels as a conundrum—and most reasonable forecasts expect them to remain so in the near future. We could worry that high deficits will cause high interest rates, but that would be, well, crying wolf.

So we are left with the termite argument, the one I favor. As the chart shows, deficits do lower national saving—of that there seems little doubt. When national saving declines, it is a mathematical truism that one of two things must happen:

a) domestic investment in capital equipment must decline, lowering America's long-term rate of productivity improvement;

b) domestic investment will not decline but the country will borrow the difference, in the form of higher current account deficits in the balance of payments.

This choice is not an assertion, it is true by definition. I could show a new set of charts here, but most of you know what happened. So far domestic investment

has held up well, and the nation has made up the difference between saving and investment by borrowing from foreigners.

I think most of you would accept the fact that if the deficit-induced decline in national saving were to erode domestic investment, that would be a bad thing. It is a competitive world out there and our nation has to invest in new equipment, keep new techniques coming on-stream, and maintain its economic strength. The harder part of the argument is on the foreign side—if foreigners persist in lending us whatever we need to keep investment high, why worry?

My colleague, Ted Truman, will address this issue in depth, but let me make one simple point. How do we know that foreigners will keep on lending to us? And at a more basic level, why should the United States put itself at the mercy of foreign lenders? One would think we should manage our affairs to keep national saving as high as we think it should be, from an optimizing standpoint. If foreigners lend to us, our own investment will be that much higher. If not, we are protected against a decline in investment by our own national saving. The basic problem with letting national saving fall is that the country becomes vulnerable.

There is also an important time dimension to the budget problem, stressed by Chairman Bernanke in his testimony to the Senate a few days ago. Soon the large baby boom cohort in the United States will hit retirement ages, and when that happens, projected entitlement spending rises rapidly. The Social Security trust fund contributes a cash surplus to the budget now, but that cash surplus will be gone in a little more than a decade and ultimately will become a big cash deficit. Simultaneously, health care spending is likely to be rising rapidly. The time to take matters under control, to get our deficits down and national saving up, is now.

Looking at this issue another way, presently the nation has a little more than three workers per retiree. In 2030 there will be about two workers per retiree. If those workers are to support the rising number of retirees, they will need more capital. They can only get capital through higher national saving. That is exactly what we should be doing today—saving at higher rates. Instead we have let the budget deficits erode national saving.

So this is the argument, Mr. Chairman. Deficits are not like a pussycat, with no effect. Nor are they likely to huff and puff and blow our house down. But they do either erode investment, or force the nation to borrow the difference, and in that way they do eat away at the foundation. Moreover, demographics is going to make the deficit problem much worse in the future than now. The time to act to get deficits under control is now.

Politics is never far away from such discussions, so I can hardly campaign against deficits without commenting on whether they should be changed on the tax or expenditure side. Basically, as a macroeconomist, I don't think it matters much. It is often argued that it is necessary to keep tax rates low. In truth, the US has probably never had a better macroeconomic decade than the 1990s, following tax increases at the beginning of the decade. There have been other eras when good performance followed tax cuts. When national tax rates get very high, there is a theoretical argument against letting them increase further, but at present moderate rates I do not think it matters much whether the budget adjustment is made on the tax or expenditure side of the ledger.

Putting this challenge differently, some politicians may like to keep taxes lower. Fine, no problem, but these same politicians must then commit to keep spending lower, making the necessary cutbacks in spending. Some politicians may like a larger and more expansive government. Fine, no problem, but these politicians must then be willing to assess higher taxes. Deficits can be fixed on one side of the budget or the other, but from a long-term economic management point of view, they should be fixed.

Chairman SPRATT. Dr. Truman, we would be happy to hear from you now.

**STATEMENT OF EDWIN M. TRUMAN, SENIOR FELLOW,
PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS**

Mr. TRUMAN. Thank you, Chairman Spratt, Mr. Ryan, members of the committee.

It is a pleasure to appear before you today as a pinch-hitter for Fred Bergsten, who is the Director of the Peterson Institute for International Economics. Fred was called out of town on a family emergency. He regrets he cannot participate in your hearing on this important topic.

I worked closely with him on preparation of his testimony. The words are his, but I fully share the thinking. These oral remarks are my own responsibility.

Fred was asked in particular, as Ed Gramlich just indicated, to address the international dimensions on why U.S. budget deficits matter. Should we be concerned that foreigners now own more than 50 percent of U.S. Treasury debt that is in private hands? Should we be concerned that foreigners own about 15 percent of the value of U.S. long-term securities? We have tables in the testimony documenting all this. Should we be concerned that at the end of 2005, the latest comprehensive data available, our net debt to foreigners was 22 percent of our GDP and our gross debt to foreigners was \$13.6 trillion, equal to almost 110 percent of our GDP?

The answer is not entirely straightforward. On the one hand—as a two-handed economist, we do not need to worry about foreign holdings of U.S. Treasury securities per se. Because of the size and liquidity of our capital markets, the form in which foreigners hold claims on the United States is of marginal importance. Who they are is also relatively unimportant, whether they are private holders or official holders. However, what is important is that foreigners as a group continue to hold existing claims on the United States in some form and continue to add to their holdings at a rate of about \$2 trillion a year to cover both our current account deficits and our capital outflows.

Our overall dependence on foreign financing is one of the major reasons why we should adopt a national policy objective of restoring the modest budget surpluses that were in place as recently as 1998 to 2001, preferably by the end of this decade, and excluding off-budget financing. If we do not put our house in order, as the phrase goes, the performance of the U.S. economy is vulnerable to an abrupt cessation of foreign capital inflows.

This is the one point I think in terms of your hearings where there is some difference between the sort of longer-term view that you have heard from David and Ned, which is certainly correct, but, in the short run, we may not have as long as we think we have, and that has to do with the vulnerability to foreign financing.

As evidence of that vulnerability, note that over the past 5 years we have only been able to attract the foreign financing to cover our current account deficits at progressively lower exchange rates—in other words, by selling U.S. assets each year at lower prices.

The cost is also rising in other dimensions. Our gross income payments to foreigners are now more than 4½ percent of GDP, compared with less than 2½ percent 3 years ago. Even with today's low interest rates, that figure is rising at about a half a percentage point a year.

In addition, we require—and this was Ned's point—a net inflow of saving from abroad to cover more than ¾ of our net domestic investment, investment that is critical to boosting the productivity of our economy as baby boomers retire. Thus, because of our dependence on foreign financing, the U.S. economy faces the risk of what is called a hard landing, not only in the form of a lower dollar, which is essentially inevitable, but in the form of higher interest rates, lower investments and a weaker economy.

Moreover, if we fail promptly to put our house in order, domestic residents may also lose confidence in our policies and seek to move their investments abroad. Their holdings of U.S. financial assets are three times those of foreigners.

Our current account deficit has been widening steadily for 15 years with only one recession-related narrowing in 2001. The deficit may be in the process of leveling out, but the prudent policy is to anticipate that the current account deficit will be cut in half, to about 3½ percent of GDP, by the end of the decade. Not sure, but that would be the prudent assumption, in my judgment.

If this process is to proceed smoothly, if we are to avoid a hard landing for our economy, which could happen even during this Congress, we should reduce our reliance on foreign savings. We should do so not by erecting barriers to foreign trade or to capital inflows but by boosting national savings. The only policy tool that we can expect with confidence to deliver such an increase in national savings is a comparable improvement in the Federal budget position.

Thank you. I look forward to your questions.

[The prepared statement of Edwin Truman follows:]

PREPARED STATEMENT OF EDWIN M. TRUMAN, PH.D., SENIOR FELLOW, PETERSON
INSTITUTE FOR INTERNATIONAL ECONOMICS

THE ISSUE

Foreigners account for about \$2.2 trillion, or a little over half, of the outstanding total of \$4.3 trillion of US Treasury securities held by the public. Official institutions, mainly central banks, account for about 60 percent of this total. In addition, foreigners as a whole probably hold close to \$1 trillion, or about 15 percent, of US government agency securities. The data are in Tables 1-4,* prepared by our colleague Doug Dowson at our Peterson Institute for International Economics.

These totals and ratios have risen rapidly over the past twenty years. From 1985 to 2005, foreigners acquired almost 75 percent of the overall increase in outstanding Treasuries. From 1995 to 2005, domestic holdings actually fell while foreign holdings grew by twice the aggregate increase. Since 2001, foreign purchases of Treasuries have accounted for most of the rise in the total outstanding.¹

These data raise the obvious question of whether the United States in general, and the US Government in particular, have become excessively dependent on foreigners to finance our domestic economy and indeed our federal budget. The ultimate concern is whether these holders, or perhaps some subset of them such as foreign governmental institutions, might precipitate a financial crisis by rapidly selling off large amounts of Treasuries for economic or even political reasons.

FOREIGN HOLDINGS OF TREASURIES

The answer to these questions is two-fold. First, we do not need to worry very much about foreign holdings of US Treasury securities per se. The US capital markets are so large and so liquid, and the Treasury market is a sufficiently modest component of it, that foreign shifts from Treasuries to other dollar investments could readily be accommodated by a reallocation of the portfolios of other investors. We should worry even less about the risk of liquidation of Treasuries by foreign official institutions, including the largest holders in Japan and China, who are the least likely sources of disruption of our financial markets in view of their responsibilities for financial stability and their institutional aversion to being blamed for any disruption of the world economy—and, unfortunately, due to the desire of many of these countries to maintain undervalued exchange rates to bolster even further their international competitiveness.²

It would in fact be a mistake to overemphasize the 50 percent share of foreign holders of US Treasuries. The reason is that Treasury long-term debt accounts for less than 10 percent of the total stock of outstanding long-term US securities (Table 3). The addition of USG agency securities, of which foreigners hold about 15 percent, leaves their holdings of all governmental paper at about 20 percent of the overall

*EDITOR'S NOTE: Tables begin on page 35.

capital market. Hence there is plenty of room for reallocation of investment portfolios by different groups of investors among different asset classes. If foreigners decided to shift their holdings of Treasuries to US agencies or corporate bonds (or bank deposits or some other assets), as they in fact seem to be doing (at least from short-term Treasury bills) in recent years, other investors would be attracted by the reduction in prices of Treasuries to make switches in the opposite direction. There might be some alteration in the relative prices of the different US assets, with a modest increase in the cost of financing the federal debt, but major disruptions would be highly unlikely.

When seen in this larger context of the entire US capital market, foreign holdings are more on the order of 15 percent. This is considerably less than their share of 50 percent in the Treasury market by itself. Foreigners hold only about 10 percent of US equities and about 20 percent of corporate bonds.

This conclusion receives strong empirical support from the experience of the last few years. Foreign holdings of Treasuries fell in 2000-01 but the exchange rate of the dollar continued to rise throughout that period. Conversely, foreign holdings of Treasuries rose sharply in 2003-04 while the dollar was declining steadily and substantially. There is simply no clear relationship between changes in foreign holdings of Treasuries and the value of our currency.³

TOTAL FOREIGN CAPITAL FLOWS TO THE UNITED STATES

Second, however, we do need to worry considerably about total foreign holdings of dollar assets and, in particular, the extent to which our economy has become dependent on new capital inflows to finance both our external and internal deficits because those inflows could slow abruptly or even totally dry up at virtually any time. Because of the direct impact of the federal budget position on total national saving, and thus on our current account imbalance with the rest of the world, I believe that this US dependence on foreign funding is one of the major reasons we should adopt a national policy objective of restoring the modest federal budget surpluses that were in place as recently as 1998-2001.

At the margin, the role of foreigners in financing the US economy is much more salient than suggested by the averages cited above: they accounted for virtually the entire increase in the total holdings of all US long-term securities, including equities and corporate bonds, from 2000 to June 2005 (the latest date for which comprehensive data are available, see Table 3). It is true that this period is distorted by the sharp fall in equity prices after early 2000 and our ratio of dependence on foreign investors is considerably lower—though still close to 50 percent—if different base periods are chosen. But the United States has clearly become reliant on external funding for a very large proportion of the investment needed to fuel our domestic economy and we need to carefully consider the implications thereof in setting national economic policy.

These financial flows are a manifestation of the very large and rapidly growing deficits in the US merchandise trade and current account balances with the rest of the world. Those deficits hit \$850-875 billion in 2006, about 7 percent of GDP. They have increased by an average of \$100 billion annually over the past four years (and by an annual average of over \$80 billion for the past nine years). Funding those deficits requires the United States to attract \$3-4 billion of foreign money (including direct investment as well as financial capital) every working day. As a result, our net foreign debt had climbed to \$2.7 trillion at the end of 2005. In addition, the United States exports capital (including direct investment as well as portfolio capital) in the range of \$500 billion to \$1 trillion every year, which must also be offset by capital inflows.⁴

Hence we must attract \$7-8 billion of foreign capital every working day to avoid significant changes in prices, mainly of interest rates and exchange rates but also of equities and housing, throughout the US economy. Any substantial diminution of the total inflow of new foreign investment into the United States from this required total would have jarring effects on our financial markets and thus on our economy. The exchange rate of the dollar would fall, interest rates would rise, equity prices would almost certainly decline and the weakening of the housing market would be exacerbated. The scale of these shocks would depend largely on whether the reduction in foreign inflows took place quickly, producing a “hard landing,” or more gradually over a period of several years (as actually occurred in 2002-03 and again, albeit sporadically, in 2004 and 2006). With the US economy now at full employment, however, unlike in 2002-03 when considerable slack existed as we recovered from the recession of 2001, a rapid and sizable fall of the dollar could generate substantial inflationary pressure and push US interest rates up sharply, perhaps even into double digits, possibly triggering a severe recession.⁵

It would not matter whether the reduced inflow took place via the market for Treasury securities or for other asset classes. Nor would it matter whether the reduction came from foreign official institutions or, much more likely, private investors. What would count, perhaps severely, would be the cutback (or, in the extreme case, the drying up or reversal) of total foreign demand for additional dollar assets. The huge inflows of foreign capital in recent years have held down US interest rates and supported our economic expansion, thus obviating for a time the “crowding out” of private investment and growth that would otherwise have occurred as a result of the large budget deficits, but they have done so at considerable long-term cost to the economy (in terms of future debt service payments to foreigners) and with substantial ongoing risk to our stability and prosperity.

Thus it would not require a liquidation of foreign holdings of Treasuries, or any other class of dollar financial assets, to cause considerable problems for the US economy. Such liquidations, from the current total of such holdings of more than \$10 trillion, would obviously make the situation worse. But we have become so dependent on additional inflows of very large amounts of foreign funds that any significant setback therein would have substantial consequences for our economy.

Some observers believe that the United States has not yet reached the point where there is serious risk of a large falloff in new foreign investment in the dollar.⁶ It is true that the ratio of US foreign debt to GDP is only about 20 percent, which is modest by historical standards. But it is also true that we are on an unsustainable trajectory: my colleague Michael Mussa, the former chief economist of the IMF for ten years and a member of the Council of Economic Advisers under President Reagan, notes that continuation of the external deficits at current levels, let alone any further increases, would carry that ratio to at least 50 percent within the next few years and ultimately to 100-120 percent. This would be exceedingly dangerous terrain for an advanced industrial country, let alone the supposed steward of the world’s key currency.⁷

Some observers also downplay the risk of any significant falloff in new foreign investments in the dollar on the grounds that “there is no place else to put the money.” That view has proved repeatedly to be wrong in the past as indicated by the sharp falls in the dollar that have occurred about once per decade over the last 35 years, notably by more than 20 percent in 1971-73, about the same amount in 1978-79, more than 30 percent (and about 50 percent against the DM and yen) in 1985-87 and (to its record lows) in 1994-95.

Currently and in the future, however, that view is even more incorrect because of the systemic change represented by the creation of the euro. The dollar was the world’s dominant currency for most of the past century for a simple reason: it had no real competition. No other currency was based on an economy that was anywhere near the size of the United States nor was able to support financial markets of the breadth, depth and resiliency of ours. The euro, however, is based on an economy that is almost as large and that in fact features considerably larger levels of international trade and monetary reserves. Hence it presents, for the first time, a true alternative to the dollar and an alternative locus for footloose international investment that might previously have come into dollar assets.⁸

Indeed, euro-denominated bonds have attracted more international investment than dollar-denominated bonds for the past two years. The US financial market (at \$48 trillion) is still considerably larger than the financial market of the Eurozone (\$27 trillion) but now accounts for only one third of the global total and the Eurozone market is growing twice as fast. The periodic diversifications by foreign central banks of their reserve holdings out of dollars are primarily into euros and reflect this new international financial reality (though all these shifts have been handled in a way that avoids market disruption, supporting the conclusion suggested above that foreign official institutions are highly unlikely to destabilize markets).⁹

THE POLICY RESPONSE

The only effective response to this potentially severe threat to US economic stability and prosperity is to substantially reduce the external deficit in our trade and current account balances.¹⁰ The goal should be to cut that deficit at least in half, to about 3-3½ percent of GDP (at which level external funding might well be sustainable) rather than the 7 percent or so at present.

This will require a series of changes in economic policy in the United States and other major countries. One essential part of the package is to reduce the gap between saving and investment in the United States by a like amount of 3-4 percent of GDP, most or all of which should be accomplished by increasing national saving since reducing investment would weaken both our growth prospects and continued

improvements in US productivity. The chief policy tool that we can deploy with some confidence to promote achievement of this objective is a shift in the budget position of the federal government over the next several years from today's deficits of 2-3 percent of GDP to modest surpluses à la 1998-2001.¹¹

It must be noted that there is no automatic link between the US budget and current account deficits. The external imbalance in fact soared anew during the late 1990s while the budget was moving into surplus (because domestic investment was running at postwar highs and continuing declines in private saving offset much of the reduction in public dissaving). In theory, there could be some offset to increases in public saving achieved by budget improvement via reduced private saving (though the two have tended to move in similar rather than opposite directions in the United States in recent decades).

The deficits were much more closely related throughout most of the 1980s, however, when both reached their previous record highs and required substantial adjustment. The external deficits would probably be much larger today had the budget not improved so dramatically during the 1990s. The tax cuts and rapid spending increases of the early years of this decade clearly worsened our external position, by further reducing national saving, and played central roles in pushing it to today's precarious levels. Indeed, less expansionary fiscal policy in recent years would have reduced the need for tightening of monetary policy by the Federal Reserve and produced a weaker dollar that would have strengthened our current account. Budget correction would almost surely promote external adjustment under current circumstances, perhaps by around one half of the improvement in the budget itself.¹²

Trade policy is not the topic of this hearing but I would note, before closing, that the creation of new US barriers to imports of goods or capital would be an ineffectual and wholly inappropriate response to our trade and current account deficits. As indicated throughout my statement, these large imbalances are a macroeconomic problem that require macroeconomic (including exchange rate) remedies. It would be particularly counterproductive to discourage inflows of direct investment or any other forms of foreign capital, which we must continue to attract as long as we run current account deficits, as might well be the result of some of the current proposals for "reforming" the Committee on Foreign Investment in the United States (CFIUS) and US policy in that area more broadly.¹³

I believe there are strong reasons to convert the current, and especially prospective, US budget deficits into modest surpluses without appealing to these international aspects of the issue. But the vulnerability of the US economy to large and prolonged reductions in foreign capital inflows, especially if they occur abruptly, surely counsel that we "put our house in order" as promptly as possible. I am delighted that the Committee is assessing these issues as part of its deliberations on the fiscal situation and hope they will help persuade you to adopt an aggressive stance to sharply improve the prospects over the coming budget cycle.

ENDNOTES

¹ Estimates of these longer trends are presented in Philip D. Winters, "Growth in Foreign Holdings of US Debt," Congressional Research Service, November 13, 2006.

² One possible caveat is that rumors of sizable liquidations by foreign official holders could spook the markets and trigger a run on the dollar. Such rumors concerning Kuwait were in fact widely cited as a factor in the sharp fall of the dollar in late 1978, the closest the United States has ever come to experiencing a "hard landing." Similar rumors in more recent periods, however, have been largely shrugged off by the markets.

³ On this issue see especially Edwin M. Truman and Anna Wong, *The Case for An International Reserve Diversification Standard*, Working Paper 06-2, Washington, Institute for International Economics, May 2006.

⁴ This large US capital outflow reminds us that Americans, at least as much as foreigners, could trigger a run on the dollar that would have the consequences described later.

⁵ Martin Neil Bailey, "Persistent Dollar Swings and the US Economy," in C. Fred Bergsten and John Williamson, eds., *Dollar Overvaluation and the World Economy*, Washington, Institute for International Economics, February 2003.

⁶ See Richard N. Cooper, "Living with Global Imbalances: A Contrarian View," Washington, Institute for International Economics, November 2005.

⁷ See Michael Mussa in "Sustaining Global Growth While Reducing External Imbalances," in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Washington, January 2005. See also William R. Cline, *The United States as a Debtor Nation*, Washington, Institute for International Economics, September 2005.

⁸ See C. Fred Bergsten, "The Euro and the Dollar: Toward a 'Finance G-2'?" in Adam S. Posen, editor, *The Euro at Five: Ready for a Global Role?* Washington, Institute for International Economics, April 2005, especially pp. 30-35.

⁹ See Truman and Wong, *The Case for an International Reserve Diversification Standard*, Working Paper 06-2, Washington, Institute for International Economics, May 2006.

¹⁰These imbalances also add substantially to the difficulties of maintaining an open trade policy in the United States. See C. Fred Bergsten, "A New Foreign Economic Policy for the United States," in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Washington, Institute for International Economics, January 2005.

¹¹Detailed scenarios for doing so can be found in Cline, *The United States as a Debtor Nation*, Chapter 4, and Mussa, "Sustaining Global Growth While Reducing External Imbalances," especially pp. 193-196. It would of course be highly desirable to increase US private saving as well. This may happen spontaneously, at least to a limited extent, from the decline in the housing market and the rise in interest rates more generally but, unfortunately, there are no policy tools that can confidently be deployed to do so.

¹²There is a wide range of estimates of this relationship but they tend to cluster around 50 percent. The main outlier is the Federal Reserve, whose much lower estimates are explained and criticized in Cline, *The United States as a Debtor Nation*.

¹³Edward M. Graham and David M. Marchick, *US National Security and Foreign Direct Investment*, Washington, Institute for International Economics, May 2006.

TABLE 1.—MAJOR FOREIGN HOLDERS OF TREASURY SECURITIES

[In billions of dollars; Holdings¹ at end of period]

Country	June 2005 (V)	June 2005 (VI)	July 2005	Aug 2005	Sept 2005	Oct 2005	Nov 2005	Dec 2005	Jan 2006	Feb 2006	Mar 2006	Apr 2006	May 2006	Jun 2006	Jul 2006	Aug 2006	Sep 2006	Oct 2006	Nov 2006
Japan	681.2	667.1	669.4	670	672.8	667	667.9	670	653.4	656.4	639	639.4	636.8	636.2	636.3	645	639.6	639.6	637.4
China, Mainland	243.3	298	296.4	302.1	306.3	301.7	303.9	310	313.9	317.2	317.4	319.2	322.3	325.4	330.4	339.2	342.4	345	346.5
United Kingdom ²	140.8	58.8	73.2	87.2	95.8	100.3	135.5	146	157.2	162.3	179.1	166.8	175	201.5	190.3	200.8	207.8	207.5	223.5
Oil Exporters ³	57.2	68.5	64.1	65.2	66.1	63.7	68.8	69	71.2	72.8	72.4	70.9	68.8	68.9	103.1	107.2	104.4	97.9	97.1
Korea	59.4	63	62.6	62.4	64.1	63.7	68.8	68.1	68.7	68.9	68.9	68.9	67.5	67.1	66.7	66.7	66	69	67.7
Taiwan	71.3	67.8	68.8	68.4	68.9	68.9	68.3	68.1	68.7	68.9	68.9	68.9	67.5	67.1	66.7	65.6	65	64.5	63.2
Carib Bnkng Ctrs ⁴	66.9	70.9	65.2	67.4	68.3	75	81.2	77.2	64	52.9	60.5	60.1	58.2	60.2	68.7	63.7	51.4	56.3	63.6
Germany	61.2	44.1	44.8	47.9	46.4	47.3	48.6	49.9	48	47.9	46.4	46.7	47.2	48.7	50.3	51.9	52.9	52.7	52.1
Hong Kong	48.7	44.5	44.7	43.6	44.4	44	42.8	40.3	44.6	44.9	46.6	49.4	48.4	48.8	48.9	50.6	49.6	50.6	51
Canada	43.8	18.5	21.4	23	22.4	26.3	28.5	27.9	29.6	33.3	34.7	36.8	40.8	41.2	42.3	49.1	49.6	49.5	47.8
Brazil	20.9	22.1	24.5	25	27.5	27.1	28.8	28.7	30.1	33.3	31.4	30.8	32.9	33.4	31.7	43.2	45	46.4	51.1
Mexico	31.9	29	32	32.9	32.1	34.9	36.6	35	36.5	37.6	40.1	41.9	43.4	45.7	45.7	39.9	39.9	40	38.2
Luxembourg	43.5	38.8	36.9	38.2	37.6	36.7	36.6	35.6	35.2	36.2	36.6	37.5	38.5	37.4	38	37	37.3	38.1	39.1
Singapore	29.9	34.4	34.1	34.2	33.9	33.9	33.4	33	32.9	33.5	33.1	36.7	35.7	34.6	34.3	34	33.3	30.5	30.3
France	19.2	23.2	26.4	28.5	28.5	30	31.3	30.9	32	34.9	34.7	30.1	30.7	29.2	25.6	26.9	21	30	33.7
Switzerland	39.5	34.9	32.3	32.9	32	32.6	30.7	30.8	30.4	31.2	30.9	31.1	30.5	30.6	31	30.9	29.8	29.7	28.4
Ireland	15.6	22.2	23.1	18.9	19.1	22.1	23	19.7	21.1	19.3	19.6	17.7	19	20	19.8	21.3	20.8	21.9	21
Turkey	13.8	15.3	16.6	15.5	14.6	15.7	18.5	17.4	18.9	21.6	21	21.6	21.5	19.1	21.8	23.3	22.9	21.5	22.7
Netherlands	13.3	19.1	19.6	18.7	18.2	19.1	16.9	15.7	15.7	15	15.3	15.4	15.4	17	16	14.4	15.8	17.6	18.2
Sweden	19.4	16.9	16.4	16.8	16.8	16.7	17.1	16.3	17.4	17.1	17.9	18	18.1	18.2	18.3	18.3	17.8	16.9	16.7
Belgium	15.9	15.4	15.6	15.8	15.7	15.4	15.6	17	16.7	17.2	17.1	17.4	17.5	17	18.4	17.8	17.1	16.6	16.3
Thailand	12.9	16.3	15.6	15.7	14.8	16.2	16.2	16.1	17	17.9	17.5	15.6	15.5	15.8	15.8	16.4	16.3	16.1	16.5
Israel	9.5	10.9	10.5	11.4	11.8	11.9	10.8	12.5	12.5	12.4	12.3	13.4	13.4	11.4	10.4	10.2	13.1	15.2	15.6
Italy	14.4	13.1	14.4	14.9	14.2	15.1	16.5	15.4	15	14.3	13.7	13.9	14.2	15.4	14.9	15	14.5	14.7	16.8
Poland	11.4	12.4	12.2	12.1	12.9	13.2	13.4	13.7	11.3	12.4	12.2	12.3	13.3	11.4	12.8	13.7	13.1	14.4	14.2
All Other	186.5	152.3	158.3	157	144.5	154	163.8	159.4	163.2	166.6	161.7	150.8	138.5	132.5	139.9	144.8	142.7	160.4	170.3
Grand Total	1971.3	1877.5	1899.2	1925.9	1929.6	1964.3	2034	2033.9	2045.9	2073.2	2078.2	2061.6	2065.7	2088.1	2099.9	2146.8	2132.1	2162.5	2199

Of which:

For Official	1236.6	1258.6	1261.9	1267.8	1256.7	1267.1	1291.8	1284.7	1299.7	1317.9	1310	1303.1	1286.8	1272.1	1281.6	1302.1	1299.2	1316.8	1325.5
Treasury Bills	204.9	204.9	203.2	205.4	195.4	199.8	214.9	201.9	210.5	216	215.5	197.5	195.1	185.1	186.3	190	179.4	178.5	186.2
T-Bonds & Notes	1031.7	1053.7	1058.7	1062.4	1061.3	1067.3	1077	1082.8	1089.2	1101.9	1094.6	1105.6	1091.7	1087	1095.2	1112.1	1119.8	1138.3	1139.3

TABLE 1.—MAJOR FOREIGN HOLDERS OF TREASURY SECURITIES—Continued

[In billions of dollars; Holdings¹ at end of period]

Country	June 2005 (V)	June 2005 (VI)	July 2005	Aug 2005	Sept 2005	Oct 2005	Nov 2005	Dec 2005	Jan 2006	Feb 2006	Mar 2006	Apr 2006	May 2006	Jun 2006	Jul 2006	Aug 2006	Sep 2006	Oct 2006	Nov 2006
Total Marketable Outstanding	4012.6	4012.6	4059.1	4087.6	4066.1	4112.5	4166.5	4165.8	4176.3	4259.5	4321.7	4264.5	4250.5	4235.1	4261.3	4325.3	4283.8	4318.6	4361.4

Department of the Treasury/Federal Reserve Board, January 17, 2007.

¹ Estimated foreign holdings of U.S. Treasury marketable and non-marketable bills, bonds, and notes reported under the Treasury International Capital (TIC) reporting system are based on annual Surveys of Foreign Holdings of U.S. Securities and on monthly data.

² United Kingdom includes Channel Islands and Isle of Man.

³ Oil exporters include Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya, and Nigeria.

⁴ Caribbean Banking Centers include Bahamas, Bermuda, Cayman Islands, Netherlands Antilles and Panama.

TABLE 2.—MAJOR FOREIGN HOLDERS OF TREASURY SECURITIES

[Share of total outstanding including bills (percent); Holdings¹ at end of period]

Country	Q2 2005 (V)	Q2 2005 (VI)	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Oct 2006	Nov 2006
Japan	17.9	17.5	17.4	16.9	15.5	15.8	15.7	15.5	15.3
China, Mainland	6.4	7.8	7.9	7.8	7.7	8.1	8.4	8.4	8.3
United Kingdom ²	3.7	1.5	2.5	3.7	4.4	5.0	5.1	5.0	5.4
Oil Exporters ³	1.5	1.8	1.7	2.0	2.4	2.5	2.6	2.4	2.3
Korea	1.6	1.7	1.7	1.7	1.8	1.7	1.7	1.7	1.6
Taiwan	1.9	1.8	1.8	1.7	1.7	1.7	1.6	1.6	1.5
Carib Bnkg Ctrs ⁴	1.8	1.9	1.8	1.9	1.5	1.5	1.3	1.4	1.5
Germany	1.6	1.2	1.2	1.3	1.1	1.2	1.3	1.3	1.2
Hong Kong	1.3	1.2	1.1	1.0	1.1	1.2	1.2	1.2	1.2
Canada	1.2	0.5	0.6	0.7	0.8	1.0	1.2	1.2	1.1
Brazil	0.5	0.6	0.7	0.7	0.8	0.8	1.1	1.1	1.2
Mexico	0.8	0.8	0.8	0.9	1.0	1.1	1.0	1.0	0.9
Luxembourg	1.1	1.0	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Singapore	0.8	0.9	0.9	0.8	0.8	0.9	0.8	0.7	0.7
France	0.5	0.6	0.7	0.8	0.8	0.7	0.5	0.7	0.8
Switzerland	1.0	0.9	0.8	0.8	0.8	0.8	0.7	0.7	0.7
Ireland	0.4	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Turkey	0.4	0.4	0.4	0.4	0.5	0.5	0.6	0.5	0.5
Netherlands	0.3	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Sweden	0.5	0.4	0.4	0.4	0.4	0.5	0.4	0.4	0.4
Belgium	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Thailand	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Israel	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4
Italy	0.4	0.3	0.4	0.4	0.3	0.4	0.4	0.4	0.4
Poland	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
All Other	4.9	4.0	3.7	4.0	3.9	3.3	3.5	3.9	4.1
Grand Total	51.8	49.4	49.9	51.2	50.5	51.8	52.3	52.3	52.7
Of which:									
For. Official	32.5	33.1	32.5	32.4	31.8	31.6	31.9	31.9	31.7
Treasury Bills	5.4	5.4	5.1	5.1	5.2	4.6	4.4	4.3	4.5
T-Bonds & Notes	27.1	27.7	27.5	27.3	26.6	27.0	27.5	27.6	27.3

Department of the Treasury/Federal Reserve Board, January 17, 2007.

¹ Estimated foreign holdings of U.S. Treasury marketable and non-marketable bills, bonds, and notes reported under the Treasury International Capital (TIC) reporting system are based on annual Surveys of Foreign Holdings of U.S. Securities and on monthly data. The total debt outstanding excludes debt held by the U.S. Treasury and other federal agencies and trust funds and holdings by the Federal Reserve Banks.

² United Kingdom includes Channel Islands and Isle of Man.

³ Oil exporters include Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya, and Nigeria.

⁴ Caribbean Banking Centers include Bahamas, Bermuda, Cayman Islands, Netherlands Antilles and Panama.

TABLE 3.—VALUE OF FOREIGN-OWNED U.S. LONG-TERM SECURITIES AND SHARE OF THE TOTAL

[Outstanding, by asset class, as of selected survey dates; Billions of dollars except as noted]

Type of security	Dec. 1984	Dec. 1989	Dec. 1994	Mar. 2000	June 2002	June 2003	June 2004	June 2005
Equity:								
Total outstanding ¹	2,131	4,638	7,767	24,703	17,904	17,941	20,779	22,041
Foreign-owned	105	275	398	1,709	1,395	1,564	1,930	2,144
Percent foreign-owned	4.9	5.9	5.1	6.9	7.8	8.7	9.3	9.7
Marketable U.S. Treasury:								
Total outstanding ²	873	1,515	2,392	2,508	2,230	2,451	2,809	3,093
Foreign-owned	118	333	464	884	908	1,116	1,426	1,599
Percent foreign-owned	13.5	22	19.4	35.2	40.7	45.5	50.8	51.7
U.S. government agency:								
Total outstanding ³	507	1,167	1,982	3,575	4,830	5,199	5,527	5,591
Foreign-owned	13	48	107	261	492	586	619	791
Percent	2.6	4.1	5.4	7.3	10.2	11.3	11.2	14.1
Corporate and other debt:								
Total outstanding ⁴	1,305	2,599	3,556	5,713	7,205	7,852	8,384	8,858

TABLE 3.—VALUE OF FOREIGN-OWNED U.S. LONG-TERM SECURITIES AND SHARE OF THE TOTAL—Continued

(Outstanding, by asset class, as of selected survey dates; Billions of dollars except as noted)

Type of security	Dec. 1984	Dec. 1989	Dec. 1994	Mar. 2000	June 2002	June 2003	June 2004	June 2005
Foreign-owned	32	191	276	703	1,130	1,236	1,455	1,729
Percent foreign-owned	2.5	7.3	7.8	12.3	15.7	15.7	17.6	19.5
Total U.S. long-term securities:								
Total outstanding	4,682	9,904	15,700	36,583	32,169	33,443	37,499	39,583
Foreign-owned	268	847	1,244	3,558	3,926	4,503	5,431	6,262
Percent foreign-owned	5.7	8.6	7.9	9.7	12.2	13.5	14.5	15.8

¹ Source: Federal Reserve Statistical Release Z.1, Flow of Funds Accounts of the United States, Table L213, row 1, minus: Table L213, row 3, plus Table L214, row 1, plus Table L206, row 1.

² Source: Bureau of the Public Debt Table 1 Summary of Public Debt Summary of Treasury Securities Outstanding, Total marketable held by the public less Bills.

³ Source: Federal Reserve Statistical Release Z.1, Flow of Funds Accounts of the United States, Table L210, row 1, less the amount of this figure determined by staff research to represent short-term securities (approximately \$587 billion as of June 30, 2005). U.S. government agency securities include all securities issued by federally sponsored agencies and corporations, as well as all securities guaranteed by the Government National Mortgage Association (GNMA).

⁴ Source: Federal Reserve Statistical Release Z.1, Flow of Funds Accounts of the United States, Table L212, row 1, less Table L212, row 3, plus Table L211, row 1, less Table L211, row 3.

TABLE 4.—VALUE OF FOREIGN HOLDINGS OF U.S. SECURITIES, BY MAJOR INVESTING COUNTRY AND TYPE OF SECURITY, AS OF JUNE 30, 2005

(Billions of dollars)

Country	Total	Equity	Treas. LT debt	Agency LT debt		Corp. LT debt		ST debt
				ABS	Other	ABS	Other	
Japan	1,091	178	572	54	86	37	66	100
United Kingdom	560	260	45	12	11	71	144	16
China, P.R.	527	3	277	56	116	7	29	40
Luxembourg	460	151	30	13	21	36	172	37
Cayman Islands	430	152	30	32	10	77	103	26
Belgium	335	18	13	1	50	38	210	5
Canada	308	221	14	*	4	18	37	13
Netherlands	262	161	17	12	6	22	36	8
Switzerland	238	129	29	4	7	29	26	15
Bermuda	202	59	24	16	12	22	48	20
Country unknown	196	2	*	*	*	1	192	1
Rest of world	2,254	811	546	63	203	96	214	322
Total	6,864	2,144	1,599	264	527	453	1,276	602
Of which: Holdings of official foreign institutions	1,938	177	1,054	63	261	17	44	322

* Greater than zero but less than \$500 million.

¹ Asset-backed securities. Agency ABS are backed primarily by home mortgages; corporate ABS are backed by a wide variety of assets, such as car loans, credit card receivables, home and commercial mortgages, and student loans.

Asset-backed securities (ABS) are securities backed by pools of assets, such as pools of residential home mortgages, which give the security owners claims against the cash flows generated by the underlying assets. Unlike most other debt securities, these securities often repay both principal and interest on a regular basis, thus reducing the principal outstanding with each payment cycle. However, some classes of ABS replace repaid principal with additional assets for a set period of time, thus holding the total principal outstanding constant.

Chairman SPRATT. Thank you very much, all of you, for your testimony.

General Walker, let me go back to one of your charts. I have forgotten one which—and they all, I think, have this underlying problem. I think we can solve Social Security. It requires that we come together, put everything on the table, bring everybody to the table. We have got a model for that, 1983. It worked. We made Social Security solvent for the next 60 years, in effect; and we can do that again.

Medicare is the conundrum. It is the big, difficult problem. And the underlying reason for that, the major reason, is that the cost

of medical care is going up at 2½ percent to 3 percent over and above the CPI, the rate of inflation in our economy, every year. As you compound that, you see the problems, the outyears looking just impossibly enormous, as you have just shown on your table. Would you agree that the real resolution of Medicare's problem is a subset of the resolution of the whole problem of the cost of healthcare delivery in the country?

Mr. WALKER. Yes, I would. Healthcare represents the single largest fiscal challenge of the Federal Government. Healthcare represents the single largest, arguably, domestic policy challenge in the United States; and the two big drivers to the Federal long-range fiscal imbalance are demographics and healthcare cost. As you can see from the numbers that I have put up, that Medicare is in five times plus worse shape than Social Security, just Medicare alone. That doesn't count Medicaid or civilian and military, you know, healthcare.

Chairman SPRATT. Healthcare entitlements, TRICARE, Medicaid, Medicare, all of them are afflicted with this problem.

Mr. WALKER. Correct. And, ultimately, I believe that we are going to have to engage in comprehensive reform of our entire healthcare system in installments over a number of years.

Chairman SPRATT. Dr. Gramlich, Dr. Truman, do you care to comment on that?

Mr. GRAMLICH. I would certainly agree. I was Chair of the Social Security Advisory Council in the mid-1990s, and the first thing you said, can we fix Social Security, yes, I firmly believe we can, and there are many ways to do it, and they are not that painful.

But the health programs, you throw up your hands at. Because, number one, the dollars are much more and the ethical issues are much worse. With Social Security, you are only talking money. Somebody gets a little bit more or a little bit less. We can deal with those kinds of questions. But, with Medicare, you start talking about denying treatments for this and that sort of thing, and you just take the whole discussion to a new level, and that becomes much harder for anybody to think about and also much harder to think about politically.

Chairman SPRATT. Dr. Truman, we were all raised on Samuelson in Economics 101; and we were taught by Paul Samuelson that we owed the debt to ourselves, so not to worry. It is fundamentally different today. Are you concerned about that? And when do we hit the wall? When do we reach the limit of foreigners' willingness to keep purchasing dollar-denominated assets?

Mr. TRUMAN. Well, the honest answer to that question is, we don't know when we hit the wall.

I was joking with Ned Gramlich yesterday that, when I was still at the Federal Reserve, we presented a presentation to the Board and FOMC, suggesting that the current account deficit was on an unsustainable trajectory. That was in 1996. We are now in 2007. I still believe we are on an unsustainable trajectory, but it is true that there is no assurance about when they are going to hit a wall.

What is true is that the costs are going up, and the risks of—because the debt is larger today, the risks are, in my view, larger. Therefore, to pick up a phrase that Ned used in another context, prudent risk management would say you should start addressing

those risks so that when the inevitable change in the availability of foreign savings comes about—and it may well be starting now because it looks like the current account is about leveled out—then you are replacing the savings that we have been sucking in from abroad by savings at home.

The alternative, the arithmetic that Ned had in his chart, the alternative is that investment will go down. Investment goes down, growth goes down, and then solving some of these other problems, right, generating the revenues that are necessary to—and the income that is necessary to generate the programs will be that much more difficult.

So I don't predict the end of the world, if I might put it that way, but I think the risk—right—the probability statement is non-zero that we could have a messy period over the next 3 or 4 years, and that is the sense in which in some sense—and that is driven by confidence in our policies, what is done here and the sense in which we have gotten our hands around some of these longer-term problems. Because our financial markets have a way of bringing home, bringing back to today the problems that we see on these charts out there 20 years from now.

But, as always, it doesn't happen instantaneously, and no set of economists can tell you what has happened, but we have had several periods of very abrupt and painful dislocative movements of the dollar and associated movements in interest rates in the last 30 years, and I think you can't rule out another one.

Chairman SPRATT. Mr. Walker.

Mr. WALKER. We have three financial deficits that are of concern and somewhat interrelated. We have a budget deficit, which we have talked about. We have a balance of payments deficit, and we have a savings deficit. There is absolutely no question that we are on an imprudent and unsustainable fiscal path. There is absolutely no question that our risk will increase over time. Nobody knows for sure when and if we will hit the wall and how bad it will be, but it is fundamentally imprudent to continue on our current path.

Chairman SPRATT. Thank you all for your testimony.

Mr. Ryan.

Mr. RYAN. I thank the Chairman for yielding.

Mr. Walker, I love it when you come and give these presentations that are extremely helpful and very valuable.

You know, our big problem is we don't seem to be able to come together for a fundamental entitlement reform, and I blame politics as a big reason for that, both sides. You know, we do seem unwilling to come together, bite the bullet, even though we know it might cost us politically, and actually fundamentally fix these things and change these things.

I am not going to ask you to give us political solutions. That is not your job. But what can we do in the form of metrics to improve our understanding and appreciation for the situation that we are in?

I think the chairman is right—he is not right when he said that we were all raised on Samuelson. Many of us may have studied him, but some of us were raised on Friedman. But he is right in saying that Social Security is pretty easy to fix. Social Security is a containable problem within itself.

The healthcare stuff is all—they are manifestations of the healthcare situation we have. So a much, much bigger obstacle to tackle.

The question that I want to ask you is in the context of this: We can fix these entitlement programs easily if we wanted to. We could just raise FICA taxes, and we could just raise the payroll tax to 25 percent and pretty much probably fix the problem.

The problem is we have two economic threats. We have the entitlement threat, which is a fiscal meltdown, but we also have globalization. We have competitiveness. We have the threat that confronts our standard of living with a new kind of sense of competition we have never seen before that confronts us in the 21st century, and so we—at least many of us believe we need to think about our international competitiveness and the competitiveness of our workers as we figure out how to fix these entitlement problems. So that is why many of us don't want to just tax our way out of this problem. Because we know, if we will do so, we will lose our prosperity and just eviscerate our standard of living.

So how do we better measure this stuff? What metrics can we use to give policymakers and the public a better appreciation for the real mix that we are in and to do so within the context of realizing we have to keep an eye on our international competitiveness so that we can enjoy good jobs at good wages so we can enjoy a higher standard of living?

Mr. WALKER. I think additional transparency in metrics are very, very important in order not only to help the Congress understand what needs to be done and to help manage the way forward but to help the American people understand where we are, where we are headed, the need for tough choices, the prudence of doing it sooner rather than later so that, frankly, they will reward members who have the courage to think about our future, rather than penalizing them and not returning them to office.

Mr. RYAN. That is exactly the question I am trying to ask. How can you shift—

Mr. WALKER. Two ways. Two ways. Number one, I and others have been involved since September of 2005 in something called the Fiscal Wake-Up Tour, where myself from the government as well as the Concord Coalition, the Heritage Foundation, the Brookings Institution and a variety of other groups, including AICPA, AGA, AARP, Committee for Economic Development, have been going to various cities around the country—we have been to 15 already; we average about one a month—to state the facts and speak the truth about where we are, where we are headed, the need for action, the consequence of inaction.

I use a number of the graphics that I have showed you there. The American people are pretty smart. They get it. They get it pretty quickly. So that is one thing we are doing. We are doing it to try to prepare the way, to till the ground so that people can end up making tough choices.

I might note Diane Rogers, who is on this Committee's staff, has been a participant in some of those past Fiscal Wake-Up Tour events.

The second thing that is, in addition to congressional testimony, one of the things I am going to be sending to every Member of Con-

gress, probably on Groundhog Day, February 2—which is my dad’s birthday, I might add—

Mr. RYAN. It is my daughter’s birthday.

Mr. WALKER. There you go. It is my dad’s birthday. On Groundhog Day I plan to send to every Member of Congress a concise, plain English summary of key financial and fiscal facts. I think it is important that Members have a foundation, a level playing field as to the past, the present and where we are headed in the future in order to help them understand this.

In the end, I would respectfully suggest that when you talk about after we improve transparency, after we impose budget controls, we are going to have to do three things: Number one, dramatically and fundamentally reform entitlement programs, and we are going to have to get the most money out of that. Number two, re-engineer, restructure, reprioritize and constrain other spending. We are going to have to get money out of that. And, thirdly, engage in comprehensive tax reform in ways that will generate additional revenues. We are going to have to get some money out of that.

And I would respectfully suggest, you want to try to minimize tax burdens in order to maximize economic growth, maximize disposable income and maximize our competitive advantages compared to other countries. At the same time, in the final analysis, you have got to have enough revenues to pay your current bills and deliver on your future promises. We are short today. We are going to get a lot shorter in the future.

Mr. RYAN. So you are saying minimize tax burdens to maximize growth and output, meaning entitlement reform. Focus on reforming the actual entitlement programs themselves more than just going down the road of just raising taxes is basically—

Mr. WALKER. Well, you are not going to solve your problem without serious adverse consequences merely by raising revenues. But, again, I don’t know anybody who is talking about that.

Again, you are going to have to do all three. Entitlement reform and probably get the most money out of that with regard to gap spending, restructuring, prioritization, constraint, and then tax reform with additional revenues. You are going to have to do all three. That is probably relative weighting.

And round one I would respectfully suggest is as follows: Social Security reform, you don’t want to do what was done in 1983. You don’t want to be preprogrammed to have to come back. There is no need to preprogram to have to come back.

Number two, round one of healthcare reform and, number two, round one of tax reform. Those three would represent a significant down payment, a significant credibility enhancement on behalf of the public and a significant confidence builder on behalf of the Congress.

Mr. RYAN. Since we are so demographically driven, since our systems are a pay-as-you-go system to a full-funded system with respect to our entitlements?

Mr. WALKER. Well, obviously, it depends on how you would go about achieving that; and one of the concerns would be is that, to the extent you have a funded system where the money does not belong to individuals, then history shows that it might get spent on other things. Let’s keep in mind that last year there was a \$185

billion Social Security surplus, and we spent every dime of that Social Security surplus, and we have been doing it for years.

Mr. RYAN. So if you go to a full-funded system, it has got to have property rights to protect the government from taking it away from people?

Mr. WALKER. Well—or at least put it in a real trust fund with real fiduciary responsibilities and liability. That has been discussed before.

For example, I have been involved in conversations over the years where there was a possibility of creating a separate account within, like the Federal Thrift Savings Plan, that would be invested in passive investments, index funds that could end up, you know, actually walling off the money so the money would not be spent. Now, depending on how much you are talking about, it could grow to a very sizable sum. But history has shown that, without some type of constraints, that the money is likely to get spent.

Mr. RYAN. Thank you.

Chairman SPRATT. Mr. Gramlich, would you like to add something to that?

Mr. GRAMLICH. Yes, I do. These programs are hard because they are social insurance programs, and you can't—you know, it is great to talk about entitlement reform, and we need it. But it is a little bit of a buzzword, you know; and I think at some point we have to get specific about what we mean.

Now, first off, we played this out a couple of years ago. There are serious risks in going to just making everything into individual accounts because there are social risks here, especially you can see it in the medical programs, that some people, just through the difficulties of health, are going to need a lot of money. So I am not sure the private solution does things.

The other thing I tell you is, on your point about metrics, Congressman, it has always seemed to me that the real problem is that people don't get this information in the form of trade-offs. For example, having been through Social Security, I think one of the most intriguing ideas about how to resolve that is to have the retirement age grow slowly with life expectancy. I mean, you know, when people are living longer and longer and longer and they are on the Social Security system, it just becomes unaffordable at some point; and if we had the retirement age grow as life expectancy grows and every person would work a constant share of their adult life and be retired a constant share of their adult life—

Well, as you know, you are all politicians, and you know that raising the retirement age is not popular. And I heard some polls on that last fall. Do you want to raise the retirement age in Social Security? And everybody said, no, we don't.

Well, that is not the question I would put. The question is, do you want to raise the retirement age or do something else, like pay 10 percent more taxes or do this or that? These questions can't be given to people in the form of takeaways. They have to be given to people in the form of tradeoffs. Do you want to do this or that? Neither one is going to be pleasant, and you have got to make the judgment.

I have always felt that that is the problem, more than the metrics. I think people in a vague sense do know what David is

talking about. They do know that the population is aging. They do know that there are going to be fewer people to support their retiree population. They do know that the cost of healthcare is rising. We all see that in our daily life. What they don't know is what the trade-off is. And I think the information that should go to people is that, do you want to work longer or do you want to pay more taxes, you know, that kind of thing.

Chairman SPRATT. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

Thank you, each one of the witnesses, for your wisdom. We need it.

You know, Congress is undergoing mandatory ethics training right now, but we have a too narrow definition of ethics. I think according to your testimony, particularly Mr. Walker's, since this is a values question, how we handle these budget deficits may be the ultimate ethics question. Because we are robbing our children and grandchildren today the way we are conducting business in this country.

The key to me is diagnosis. If we believe on this committee in a bipartisan basis that it is cancer, as Mr. Walker said, and not a bad cold, as some people would like to suggest, then the treatment options become more agreeable. It is never fun to undergo radiation or chemotherapy, but if you have got cancer, that can be your salvation. So I want to work on the diagnosis.

You all agree that deficits do matter. I think it is a problem sometimes, though, getting us to realize the implications of that. For example, Mr. Walker mentioned how every penny of the Social Security surplus has been spent. In my opinion, one reason that happens is because we only report the net deficit number, which allows us to hide the gross borrowing figure and the fact that we do make off with the Social Security surplus every year.

The President has held a couple of press conferences bragging about how small the net deficit is, but he has always omitted the gross borrowing numbers and so much of that money, 185 million, was borrowed from Social Security and spent on other things not related to Social Security.

Another way of measuring the deficit is to use what businesses across America use, which is the accrual deficit number or net operating costs. The President has never mentioned that deficit either. Precious few people in Congress have mentioned it, but that says that the deficit is 450 billion or 760 billion, not in the 200 billion range. And that is a number that Rotarians across America and Lions Club members, Civic Club members can relate to because that is the way they are required to measure their business. They cannot pretend back home in Main Street, America that pension and health care liabilities are not liabilities. Only the Federal Government is able to do that.

As you know, business was required to account for pension and health care liabilities back in 1992, State and local governments have had to do it in recent years. The Federal Government is the last holdout. So I am worried that this committee operates in an air of unreality.

You mentioned the Medicare drug bill, \$7.9 trillion present value liability added to our books, and one of the reasons we were able

to vote on it is because the Budget Committee under prior leadership pretended under our little budget window that if the bill came in under 400 billion it was okay for us to vote on. That was, as Bruce Bartlett, a Reagan economist, has said, possibly the worst bill ever passed in American history because it is one of the least funded bills ever passed.

So I am worried that this committee sometimes unintentionally under old rules contributes to the air of unreality. And the two primary airs of unreality are not only hiding the fact that we are stealing the Social Security surplus but also the fact that according to the chief actuary of Social Security, Social Security isn't even a promise, it is a scheduled benefit. Beneficiaries, even though in all of our speeches we say it is a sacred commitment, untouchable, as an accounting matter it is completely discretionary with the Federal Government.

So those are the issues I am concerned about. Let's focus on diagnosis. Then the treatment options will seem a lot more palatable. Any comment?

Mr. WALKER. Yes. First, let's talk a little bit about metrics. For fiscal 2006 there are three annual deficit numbers. The first is a unified budget deficit, \$248 billion. The second is the on-budget deficit, \$434 billion. The third is the net operating cost accrual, \$450 billion. But of that 450 there was a significant actuarial gain, so but for the number dealing with the VA the number would have been much higher.

With regard to pensions and health care, the Federal Government is already ahead of the private sector on accounting for employer-sponsored pension and health care costs. We book the entire unfunded liability for pension, accrued pension and health cost for civilian and military employees, and that is on the books.

However, the Federal Government is not where it needs to be with regard to accounting for social insurance programs. I do not believe for a variety of reasons which I won't go into here that you want to book a liability for the \$40 trillion that I put up. I don't think it is appropriate, I think it is misleading, and we shouldn't do it.

However, I do believe that we ought to have more transparency with regard to fiscal sustainability and generational equity and I do believe there is an additional liability that ought to be booked. Do any of you realize that the bonds that are in the Social Security and Medicare Trust Funds are not deemed to be a liability of the United States Government. You will not find it on the financial statements of the U.S. Government. That is wrong, in my view.

We took the people's money, we spent the people's money, we replaced it with a bond that is guaranteed by the full faith and credit of the United States as to principal and interest. It is in the so-called trust fund, which isn't really a trust fund. We will honor that commitment. Whether or not we will honor things beyond that is a different question but we will honor that, and I think that needs to be changed. So we do need to change our financial reporting and quite frankly the other thing you need to do on the budget, I would respectfully suggest that you need to disclose the discounted present value dollar cost of any major spending and tax proposals before you vote because there is a lot of gamesmanship

that goes on to where the costs explode beyond the 5 or 10-year horizon and that is just when our wave comes in. That is when the wave crest is beyond that 10-year horizon.

We are shooting ourselves by doing that.

Chairman SPRATT. Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman. General, I love to hear your testimony. It is a breath of fresh air. It is a true wake-up call. I have got a couple of questions, one for you, then one for all three of you gentlemen. You talked about working together for fresh air and sunshine with a lot of different organizations throughout America to let people know exactly what is going on. When it comes to the problem of entitlements if there's 435 Members of Congress, there's 435 different ways to handle how we need to go forward, whether they are spending caps, whether it is reconciliation legislation or whatever.

Is there anything that you are doing right now, and if not I would encourage you to get these groups together, General, whether they be conservative, moderate, liberal, doesn't matter, and work a road map. Are you doing anything like that right now to give us a road map and in doing that are you thinking about major wholesale changes, and I think that might be wrong because I think I heard you mention several times doing it in kind of a step fashion.

Second question to all three of you gentlemen, we talk about national savings, we talk about Social Security, one of the pieces that they have talked about is a personal retirement account that has an individual's name on it that is money just for them. This is not a novel idea. But my question to you is doesn't it make sense to proceed with something like that but start it in the first year of someone's life, whether it is incentivize or give them or whatever, I don't know. We are missing 18 years of productivity and sometimes more if they go into the higher ed market or something like that to encourage national savings that you can add, take tax breaks out for something like that. Just throw those two out to you.

Mr. WALKER. First, the organizations that are involved in the Fiscal Wake-Up Tour agree that our financial condition is worse than advertised, they agree that we face large and growing structural deficits to the known demographic trends in rising health care costs and that tough choices are required, the sooner the better.

They generally agree that you are going to have to look at all the elements that I have talked about, although there are disagreements between the individual groups about how much of the gap should be closed through entitlement reform versus spending constraint versus tax policy, tax reform and additional revenues.

My personal view is that I think this Congress needs to seriously consider whether or not you form a credible, capable and bipartisan commission to do three things. Number one, come up with a comprehensive reform to Social Security. I could write it in 3 minutes and exceed the expectation of every generation of Americans. Number two, round one of tax reform; and number three, round one of health care reform. I also think that you might need to think about some budget and additional transparency things if they don't get acted on before that.

Congressman Wolf and Senator Voinovich have such a bill that they have just introduced in this Congress. That is a way, it may not be the way. There are other bills that are emerging. I know that Senator Domenici and Senator Feinstein have introduced a bill. There are other Members such as Senator Conrad and Senator Gregg that would prefer to do something that is not a commission, would prefer that something be created that is only Members.

You are going to have to have a package that is credible, that you can focus on in order to make the tough choices, in my view. I think we can help there. I know I can help there and would be happy to do it.

With regard to the last issue, individual accounts. I would respectfully suggest that, and we should not look at things in isolation. Let's take retirement income security. Social Security is the foundation of retirement income security in America. It is the only thing that is nearly universal. In the private pension system only about 50 percent of full-time workers have a pension plan. And most of those are in defined contribution plans, individual accounts.

The savings rate in America for individuals, negative in 2005. The last year that happened, 1933. Wasn't a good year for America. All right. I would respectfully suggest that you need to think seriously about reforming Social Security, making it solvent, sustainable and secure as a defined benefit program with potentially a supplemental individual account on top for a lot of different reasons as a way to try to enhance personal savings, as a way to provide a pre-retirement death benefit, as a way to help finance long-term care and a variety of other things. We need to start looking comprehensively.

Mr. GRAMLICH. Yes, Congressman. I will just talk about the last issue, the individual accounts. I actually agree with I think what you are thinking and what David just said. I do think we need—I do think it would be a good idea to have accounts on top of Social Security. Indeed, I recommended that 10 years ago when I worked on Social Security.

But there is a pitfall and we have got to be very careful about this. From an economic standpoint the problem is low national saving, and so if we get in the position of having to give away too many tax advantages to get people to save; if for example to get me to save a dollar you have got to give away a dollar from the budget, then national saving hasn't improved.

We have got to focus on the sum of government and private saving. If private savers are going to respond to tax incentives, that is great and it might be a good idea, but we have actually had a lot of saving incentives in the tax system over the past 25 years and still the private saving rate has gone down.

So we have to be very careful about this and not give people tax inducements to save when they are not going to increase their saving because if we do that then national saving goes the wrong way.

Chairman SPRATT. Mr. Allen.

Mr. ALLEN. Thank you, Mr. Chairman. Thank you all for being here. These challenges are so great. One thing is absolutely obvious to me, we cannot solve them except on a bipartisan basis. They are simply not subject to resolution by one party or the other. And I

think that where Mr. Ryan was saying we can't just tax our way out of these problems, I agree with that. We also can't just reduce spending on these entitlement programs and get out of the problem that way.

I do think that probably no place in the Congress reflects the debate over these issues better than the debates we have had in this committee over the last few years and there are some things like sometimes I think we are stuck in the 1980's debate about the role of government all across the range here and I wanted to bring up one point. The President did—this is from a Wall Street—I am sorry, a Washington Post summary of one issue and it begins: President Bush wrote in a Wall Street Journal op-ed 2 weeks ago that, quote, it is also a fact that our tax cuts have fueled robust economic growth and record revenues. And the Post says: The claim about fueling record revenue is flat wrong.

And they go on to discuss studies by Greg Mankiw, well known to the administration, by the Congressional Budget Office and by the Treasury, which basically make the point that tax cuts generate only—in terms of additional revenue, tax cuts generate only a fraction, a relatively small fraction, though of course it is debatable, of the loss in revenue. So the tax cuts cause the deficits to go up in a significant way, in fact citing the Treasury study, the Post says that those who did that study concluded that economic—let me go back to another point here. Since the Federal Government collects about 18 percent of gross domestic product and taxes enlarging GDP by .7 percent, which is what they say would be the impact of making the Bush tax cuts permanent, would result in an extra tax revenue equivalent to 0.13 percent of GDP. That would offset less than a tenth of the revenue that would be lost because of the tax cuts.

It seems to me that we have got to get a balance here in terms of how we think about additional taxes to deal with this unprecedented pressure on our entitlement programs and how we deal with reform itself. So my question to you is since tax cuts increase the deficit and since you have said, Mr. Walker, let's start with you, that there needs to be some tax reform which goes to added revenue, what do you suggest? I mean how do you best keep economic growth continuing and still generate added revenues to deal with these entitlement programs? What would you recommend?

Mr. WALKER. First, there is a lot of misinformation and disinformation in this area. A few key points. Not all tax cuts stimulate the economy. Very few tax cuts pay for themselves. The only studies that I have seen where tax cuts potentially pay for themselves are dramatic reductions in marginal tax rates and significant reductions in tariffs. There is a difference between whether or not you generate more revenues and whether or not you generate as much revenues as otherwise you would have had if you didn't have the tax cut. Merely due to inflation we are going to generate more revenues. I mean you can see that with AMT. We don't index the AMT and more and more people are subject to that if you don't end up doing something about it.

There are several things we need to do. One, we need to focus on the tax gap, it is \$345 billion. We need additional information returns, we need additional withholding. We also need to engage

in more fundamental tax reform to simplify the Tax Code that would broaden the base and try to keep rates as low as possible but broaden the base in order to facilitate compliance and enforcement among other things.

We need to put tax preferences on the table. They need to be subject to periodic review and reexamination. We forego \$700 to \$800 billion a year in revenue due to tax preferences. It is backdoor spending. It is not on the budget, it is not in the appropriations process, not in the financial statements. Needs to be on the radar screen, needs to be reviewed just like spending. Ultimately I think we are going to need to think about moving towards a consumption-based type of tax.

Mr. GRAMLICH. A couple of points, Congressman. First off, I would agree with both you and David that in general tax cuts don't pay for themselves. The other thing, if you think about it, in the short run tax cuts do stimulate output in spending some, but spending increases do as well. And I don't think there is, and the evidence I know of would not suggest a huge difference.

On your broader question of how can we possibly do it, well, it may not be that hard. In the 1990s, not that long ago, we had a period where we actually had government surpluses. If you remember my chart there, government surpluses were high, national saving was high, and that was one of the better decades ever in American history. So it is not necessary to run deficits to have a good economy.

In the very recent history we have shown that you can have a very fine economic outcome with government surpluses and high national saving.

Chairman SPRATT. Mr. Bonner.

Mr. BONNER. Thank you, Mr. Chairman. Mr. Walker, I am going to try to break from the mold of the previous question which took 4 minutes and 30 seconds, only to give you about 30 seconds to respond. I would like for you to talk a little bit more about your most recent answer to Mr. Allen and that is your views on a consumption tax.

Mr. WALKER. Well, I am not a Ph.D. Economist but I do a lot of reading and you do have two Ph.D. Economists here. But I think what I do know is several things. Income and wealth in the United States are distributed fundamentally differently today than they were in the early 1900s when our income tax system came into place.

Secondly, the world economy is fundamentally different than it was in the early 1900s; and thirdly, that one of the things that we need to do is that we need to encourage real savings in order to stimulate investment, in order to enhance R&D, in order to improve productivity, in order to stimulate additional economic growth and further grow our standard of living. All right.

And most research that I have read would say that while you will probably never move away from an income tax in toto, but to the extent that we can do more consumption-based taxation, it is better for economic growth, it is a better chance for us to have more savings and generate all of those positive aspects that I just talked about.

The last thing, quite frankly, a lot of the special savings incentives don't work. They don't really generate real additional savings broadly, and I think when I talked before about potentially an additional individual account on top of Social Security, I was talking about mandatory savings.

Mr. BONNER. Would either of those two gentlemen?

Mr. GRAMLICH. First off, I was talking about mandatory saving on top of Social Security as well. On your point, Congressman, I think most economists if you catch them in a classroom talking to undergrads, they would probably argue that if you could start over a consumption tax system would be better than an income tax; that you would in effect tax people on how much they take out of the system, not on how much they put into it.

I think most people in their heart of hearts would prefer that. But economists have worried about this issue for years and years and it is incredibly hard to get from one tax system to another, raising hundreds of issues. So I think a lot of people who even in their heart are consumption tax advocates have just gotten ground down by the problems in transitioning from one system to another.

In the particular case I think you have to be very careful of these hybrid situations because right now the tax system is giving saving incentives but it also gives you full write-off on your borrowing so I can borrow on my house, claim the interest deduction, and save tax free. And so the government loses and I may not save any more. So you have got to be very careful of these hybrid systems.

If we go all the way to a consumption tax that would be great, but it is very difficult to do, I think maybe even harder than solving Medicare. So I just give you those words of caution.

Mr. TRUMAN. Two points here. One is I think the crucial point, and this builds on what Ned Gramlich just said, is whether a consumption tax would be more efficient in terms of raising a given amount of revenue especially given the transitional problems. That is a very complicated issue, especially in the transition area. The second point, just to emphasize again but put a slightly different way, there is—the reason why the academic and his undergraduate classroom favors consumption taxes is because you say you are taxing consumption but you are not taxing savings, and savings adds to investment and that helps. But the problem is if it is easier to save but you only have a target to save X, right, you will still save X.

And so by not taxing the savings there is no assurance that you will increase savings. That is the lesson of all the gimmicks that we have used through the tax system and other things to increase savings, not to, to go back to the earlier question, not that we don't save too little, not that I don't think it is a good idea to teach our children or grandchildren how to save. My grandchildren have one piggy bank for savings and one for spending, I think that is a terrific idea. But don't fool yourself that you can make it up because this is the difference between what we economists call income and substitution effects. And the net may be no more savings for the economy as a whole, and if you are interested in generating savings for investment in order to support when you get down to two workers per retired person, you need a bigger capital stock in order to support those people.

Chairman SPRATT. Allen Boyd.

Mr. BOYD. Thank you very much, Mr. Chairman. This is like my second or third hearing and I tell you what, I am intrigued by the subject that we are doing here and really enjoying it. I was thinking this morning we went yesterday from a first grade lesson in budgeting that we went through to something today that is as complex as how do we solve the long-term budgeting problems of our country.

My question, I am going to be very brief, Mr. Walker, I think that you answered a question a few moments ago to Tom Allen about which tax cuts pay for themselves. And I wanted you to clarify. I thought I understood you to say that dramatic cuts in marginal tax rates and also you mentioned tariffs. Would you restate that and elaborate?

Mr. WALKER. The research that I have seen, but my colleagues here on the panel may want to jump in, is the two that potentially could pay for themselves would be dramatic reductions in marginal tax rates like what happened when JFK was President. You are talking about huge reductions in marginal tax rate, not several percentage points, and dramatic reductions in tariffs, which promotes additional trade and economic growth.

Mr. BOYD. So the presumption would be you have to have a very large marginal national tax rate to start with to get a dramatic cut.

Mr. WALKER. That doesn't mean there is not some positive economic stimulus. There is a difference between paying for themselves and being stimulative. That is my key point. As Dr. Gramlich said, additional spending can stimulate economic growth at a price. Tax cuts can stimulate economic growth at a price as well. What is going on right now is we have a national credit card with no credit limit and we are charging it and our kids are going to have to pay off the bill with compounded interest costs.

Mr. BOYD. I think I understand.

Mr. GRAMLICH. Just to elaborate on one point. The starting point matters in this business because if you have a situation let's say 90 percent marginal tax rates, which we have had in this country, and you cut it to 80 percent, you know, you may well get a big increase in effort and tax revenue and so forth. If you go from 36 to 34, you know, that is a different issue.

Mr. BOYD. I understand. The next question, if I could, Mr. Walker. In terms of this discussion about our economy and the budget problems that exist, the long-term issues related to deficits, the mandatory spending programs, the crisis that faces us 10 or 12 years down the road, at what point in time do the national, international markets begin to react to that gloomy crisis. Would you be willing to expound on that?

Mr. WALKER. Only God knows. In all seriousness. I mean—

Mr. BOYD. But it happens at some point in time.

Mr. WALKER. In my view there is no question that ultimately we will pay a price. The question is what will that price be. One could argue that we will have a gradual erosion over time rather than a sudden catastrophic event. A gradual, continual erosion in the value of the dollar, a gradual increase in interest rates over time, a gradual drag on economic growth, on standard of living and a variety of other issues. That is a possible scenario, rather than a cat-

astrophic event, a precipitous decline in the dollar, a dramatic increase in interest rates.

But the bottom line is as we know we are on an unsustainable path so we ought to do something about it.

Mr. TRUMAN. I think that is the point. You have had several occasions in our history, right, where the movements in the exchange value of the dollar, in the early 70s, the late 70s, and the late 1980's have triggered very unpleasant periods in our economy, maybe not a full-fledged hard landing but in the late 80s, for example, we had a period of very low growth and part of that was that we were cutting ourselves off from foreign savings, right, and domestic savings wasn't picking up and so we damped investment, and it was a period in which GDP growth was low, we ultimately had a recession but that had more to do with oil prices.

So you can easily go through that period as David Walker was just saying, that makes things no big crisis, though in 1987, just to remind you, in 1987 the dollar was falling, right, and we, I say we because I was then part of the government, we begged the foreigners to come help us and they said we are not going to help you until you have a budget summit which will put on the table a credible commitment to cut the budget deficit. I think it was all of \$76 billion, but the point is there was a sense at that point that that issue—with the weak dollar following the stock market crash in October 1987—came right into this hearing room in a very painful, painful, painful way and it was all against the background of very slow growth. Very slow growth means that these 10 percent rates of increase in revenues aren't going to be there.

I think no one can say when. The question is how long do you want to take the risk that it is not going to be; another decade or not.

Mr. BOYD. Thank you very much. Mr. Chairman, thank you.

Chairman SPRATT. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman. I thank the panel as well. We will start off with I appreciate one of the opening comments that you made with regard to your wake-up tour that you are traveling around the country about. I just learned of that yesterday. I would invite you all to come to my home State which is the great State of New Jersey where we may need the wake-up.

Our State is going through equally difficult budgetary times. Where other States saw revenue increases and be able to cut their taxes, New Jersey is in dire straits right now financially. We were supposed to have a budget forum recently to try to solve those problems and instead they dealt with other social issues as well so we are on the same cusp in our State.

We have taken a different tact in the State of New Jersey. Whereas Congress has in the past several years cut taxes to try to stimulate the economy and that sort of thing, New Jersey has gone the other direction and has actually raised taxes. The result is what you see right now and the dilemma that we face and, as Ronald Reagan used to say, people vote with their feet, and last year 60,000 people voted with their feet and saw a decline in our population. I welcome you to come and educate our State.

I commend the General's comment. At the opening comment he made two statements. One is we should be looking forward in this

committee and not in the rear view mirror. We can debate all day long as to what the problems were but we need to look forward and I appreciate your last slide with the grandkids as to who it is all about.

This Congress passed last session the increase in the benefits for Medicare and it is true, and correct me if I am wrong, that people that are receiving that benefit today are not the people who are paying for it nor is this generation really paying for it, it is your grandkids and other grandkids who will be paying for the beneficiaries today.

So I go to my first question is the structural reform that you mentioned, how do we get to the structural reform, and ask for the comments in this sense as far as entitlement reform based upon two comments you all made. One is to minimize the tax burden, this was the answer to Mr. Ryan's question, to minimize the tax burden is to increase economic growth; so is the converse true, to increase the tax burden to decrease economic growth.

And also in light of Mr. Gramlich's comment, a better tax system would be not putting a tax you put on the system but a tax you take out of the system. Since I may not have enough time on this I will ask my last question now and you can answer these, and that is going to the Social Security and the whole issue of tradeoffs. Mr. Gramlich, you said we need more transparency and more of a show to show the tradeoffs to people. Can we do anything with regard to the information that recipients get every year in our Social Security packets or statement on your birthday every year as to show the people what the tradeoffs really are. This is what my investment today is in Social Security, but show them really what their tradeoffs are in the future as far as the alternatives they could have gotten had they been in other markets.

Thank you, gentlemen.

Mr. WALKER. I will touch on a couple. First, bad news flows downhill. We are talking about the Federal fiscal challenge today. State and local governments have their own fiscal challenges. And for those that are interested in having a Fiscal Wake-Up Tour come to your State, Bob Bixby, who is executive director of the Concord Coalition, is the point person. He is the one that schedules the different visits. And we have not been to New Jersey yet.

Secondly, my point on taxes is you want to try to minimize tax burdens in order to maximize economic growth, maximize disposal income, and maximize our competitive advantages. But, in the end, if you don't want to mortgage the future of our kids and our grandkids and if you want to mitigate the risk of the imprudent and unsustainable path that we are on, you have got to have a situation where ultimately we are going to generate enough revenue to pay our current bills and deliver on our future promises. So we need to recognize that we can't have it all.

Mr. GRAMLICH. Just a quickie on your very last idea to make what are known as the PEB statement, personal earning and benefit, even more complicated by putting in these tradeoffs, I don't think people would understand it. I would rather have the PEB statements go out just as they are now but have the fiscal wake-up tour go around and explain the issue because it is—there are too many options. You can't put in something about the retirement

age or something about this or something about that and have people have any clue what they are getting. I think it would just confuse people. And I would rather have it done with a little instruction and then focus groups and that kind of thing. I think you get farther that way.

Chairman SPRATT. Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman. Several people have mentioned this commission idea. The only problem with the commission is that suggests a one-time fix and then it is solved. Like Social Security, you had a commission and solved it for 5, 10, 15, maybe 20 years. But if you have the one-time fix, the following year you can just mess it up all over again. We had this thing pretty much on the right track in 2000 and all of a sudden it got messed up.

Unless you have some people willing to continually make the tough choices, you are not going to get very far with a one-time commission.

The Social Security question, let me, Mr. Walker, ask you a question. You have—on your long-term fiscal exposures you had Social Security benefits at 3.8 in 2000 and 6.4 in 2006. Does that mean we could have fixed it with 3.8 in 2000?

Mr. WALKER. Yes and no.

Mr. SCOTT. For 75 years.

Mr. WALKER. Yes, but the next year we would have had a deficit. And the reason being is because of known demographic trends. What is happening right now, in the short term we have surpluses, so every year that passes we drop a surplus year and we add on to the end of 75 years an increasing deficit year. And that is why it is important that we recognize that reality and that the next time there is a commission we try to do something to try to assure sustainability beyond that.

Mr. SCOTT. Could we have paid 75 years with 3.8?

Mr. WALKER. We could have, but we wouldn't have solved the problem.

Mr. SCOTT. Now 75 years is going to cost 6.4.

Mr. WALKER. It goes up about \$600 billion a year.

Mr. GRAMLICH. Congressman, could I interrupt? There is a way to deal with this, and we got it in our dealing with Social Security. When you have groups come together the wrong question is to make the system sustainable for 75 years because, as David said, 1 year passes and all of a sudden it is out of balance.

The right way to do it is to make it sustainable for 75 years and have no change in what is known as the trust fund ratio in the last 10 years because that is the ratio of assets to spending, basically, and if that ratio is stable then you can presume that as we go forward it won't change in the 11th year, the 12th year.

Mr. SCOTT. If you fixed it, the next year you would have a different 75 years. But if you could fix it to 75 years, that gives you 75 years starting off now to fix it for the next 75 years. Maybe another program or something. But we could have fixed 75 years for \$3.8 trillion.

Mr. WALKER. Correct. Importantly—

Mr. SCOTT. It gets worse as you go forward. Now we had a surplus of 5.5. How much—what is the present value of making the tax cuts permanent?

Mr. WALKER. I will be happy to provide it for the record.
[The information follows:]

GENERAL WALKER'S RESPONSE TO MR. SCOTT'S QUESTION ABOUT THE VALUE OF
PERMANENT TAX CUTS

CBO's January 2007 outlook shows the cumulative difference—not present value—between assuming the 2001 and 2003 tax cuts expire and making them permanent to be \$1.9 trillion over the period 2008 to 2017. This estimate does not include extending the 2006 AMT adjustment into the future. If the higher AMT exemption amount is extended then the cumulative difference of these changes would rise to \$2.8 trillion over the 10 year period. Under CBO's baseline in which the tax cuts and the increased AMT exemption are allowed to expire, revenues reach 20.1 percent of GDP in 2017. In contrast, if the tax cuts are made permanent and the 2006 exemption is continued, revenues would be about 18 percent of GDP in that year.

Calculating the present value of the tax cuts over a longer period of time is more difficult because it is less obvious what the reference point should be.¹ Because of inflation, bracket creep, and the alternative minimum tax, current tax policies if left in place would result in revenue as a share of GDP approaching 24 percent by 2050. It does not seem reasonable however to use this as the point of comparison—in the years since the end of World War II Congress and the President have taken actions to keep the overall tax burden within a relatively narrow range around an average of about 18 percent of GDP. Any analysis of the present value of any tax cuts would need to make an assumption about the level of future taxes to use as a comparison.

Mr. SCOTT. It was 12 trillion a couple of years ago. Does that sound about right?

Mr. WALKER. I can tell you this, as I showed, even if you don't make the tax cuts permanent, you are still going to have to do more. But that is obviously a big number.

Mr. SCOTT. A couple of years ago make the tax cuts permanent was equivalent to the present value of the Social Security Trust Fund 75-year deficit and the Medicare Trust Fund 75-year deficit.

Mr. WALKER. Not the Medicare; no way it could have been that big. We were in the hole \$15 to \$20 trillion on Medicare Parts A and B before Medicare prescription drug was passed. And so it wouldn't have been the combination of both Social Security and Medicare. It did exceed Social Security, there is no question about that.

Mr. SCOTT. The top 1 percent we are going to get out of making the tax cuts permanent was in the same order of magnitude as the Social Security 75-year trust fund.

Mr. WALKER. By itself, right.

Mr. SCOTT. Let me just get in one more question. The trade deficit and the capital deficit, we have a capital deficit now. What does the trade deficit do to that, the combination?

Mr. TRUMAN. We have actually, as was put in the 2006 Council of Economic Advisors report, we have a surplus on capital because the surplus is coming in to pay for our trade deficit. The problem is that the trade deficit represents the fact that we are adding currently to our consumption at a higher rate than we are adding to our production. And so we send IOUs abroad in order to finance our current consumption. So we are not sending the IOUs internally, as we said before, we are sending them abroad. Ultimately

¹A 2004 paper by Brian Jenn and Donald Marron when they were economists at the Joint Economic Committee noted the problems in comparing the cost of extending the tax cuts to "current law" when current law—as noted above—would project taxes as a share of GDP at levels exceeding the post-World War II average by more than 5 percentage points. (See "The Long-Run 'Cost' of Tax Cuts" by Brian H. Jenn and Donald B. Marron, in *taxanalysts* July 20, 2004)

at a minimum we are going to continue to pay interest on those IOUs and so that goes up just like the interest on the debt here and we will have to at a minimum probably have to stop piling up those IOUs because they will exhaust the appetite for those and ultimately conceivably we will have to pay off some of those IOUs. So we have to pay the interest all along, we have to reduce the rate at which we are piling up IOUs and we may have to pay them off and that means you have to bring down the current account deficit in order to attract that and bring up the trade balance in the process. I hope that is clear.

Chairman SPRATT. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. I am certainly happy to hear from all of our panelists on this subject, on why deficits matter, although I am not sure it is much of a subject of debate within this committee. I am hopeful that you can all return and in the future we can have a hearing entitled while spiraling unfunded obligations and entitlement spending matters, which I believe is, from the testimony I hear, clearly a place where this committee needs to put some focus.

General Walker, I don't have the slide number here but I am looking at one of your handouts, Composition of Spending as a Share of GDP Under Baseline Extended, August 2006. If I am interpreting this correctly, under these base assumptions all the tax relief that many believe is the root of all evil expire. We do not have an AMT patch, and yet by 2040 we still have apparently spending as a percentage of GDP go from roughly 18, 19 percent of the economy to roughly 30 percent. I am just eyeballing it.

Mr. WALKER. It goes from about 20 percent, a little over 20 percent of the economy to about 30 percent.

Mr. HENSARLING. From roughly 20 to 30, which would suggest on kind of back of cocktail napkin math I believe the average family of four in the U.S. pays roughly \$20,000 combined in Federal taxes. That would seem to suggest an increase of 50 percent in their tax burden to balance the budget by 2040. So in inflation adjusted terms might their tax burden go up to 30,000 a year?

Mr. WALKER. If you saw that solely through tax increases, which I don't know anybody who is proposing that, and if you waited until 2040 to do it, then you would have to increase tax burdens by about 50 percent, but then again you have to keep in mind that is only at that point in time. If you look out further from there we have still got a long range problem so that wouldn't solve it. Similar to the 1983 Social Security, we solved it for 75 but we didn't solve it long term for the reasons Ed Gramlich talked about.

Mr. HENSARLING. But for those who do not wish to engage in a bipartisan dialogue on reform of entitlement spending, if you take away again the Bush tax relief, ultimately then you would be looking at what I believe many would view as an unconscionable tax increase upon American families and our economy.

General Walker, speaking of tax relief, I think I heard you say that from your perspective in order for tax cuts to quote, unquote, pay for themselves I think you have said only significant decreases in marginal rates and significant decreases in tariffs would meet that criteria. But recently we had a rather dramatic decrease in the tax gains cap rate, and if I did my homework correctly, we have

doubled our capital gains realizations from 269 billion in 2002 to 539 billion in 2005, which has led to a 45 percent increase in tax revenue from these realizations.

Would cap gains be part or not part, if properly designed, part of a tax relief package that might pay for itself?

Mr. WALKER. Well, first I would say that I don't think you can look at the capital gains in isolation, I think you have to look at what has happened in the capital markets during that period of time, what has happened to real estate prices, stock and bond prices and things of that nature. One of the things that happened to us in the late 1990s is we assumed that—or the early part of this millennium, we assumed that the past was prologue and gains turned into losses and they were carried forward. The others may have a comment.

Mr. GRAMLICH. Just on that, I don't know what the answer is but you have to be careful of these realizations because it could be the bigger number, the 500 was just pulling money out of some other year. That is the problem with these capital gains realizations. You have large accrued gains and then the question is when you realize them, and if you realize them this year, you may not realize them next year. So you have to consider all years in that kind of calculation.

I don't know how it would come out, but I do know that these are tricky calculations for capital gains.

Mr. HENSARLING. In the less than 20 seconds I have left, just to make sure I understand what I heard earlier, General Walker, I think I heard you say something along the lines we cannot grow our way out of this problem and perhaps we can't tax our way out of our problem. Is it fair to say that in your opinion the most important fiscal reform we could undertake is trying to find some bipartisan reform to the growth curves and entitlement spending?

Mr. WALKER. There is no question that is number one. By the way, with regard to your question and Mr. Scott's question, of the two commissions that are on the table right now, I am sure many others will be, one is a one-time commission that has a broad scope. That is the Wolf-Voinovich commission, that includes a broad scope, and is a one-time group. The Domenici and Feinstein commission deals solely with entitlements, so it is narrow scope—but it is permanent, or long term.

Chairman SPRATT. Mr. Etheridge.

Mr. ETHERIDGE. Thank you, Mr. Chairman. Let me thank you for the opportunity to participate in this and thank you three gentlemen. Someone said earlier and I think it is true, all of us get an education here and I wish more citizens could see it, hear it and be a part of it.

I believe, Mr. Walker, you said earlier we have a budget deficit, balance payments deficit, and a savings deficit. I think we can probably agree on that. Let me ask one other question and maybe all three of you maybe want to comment on this because usually what happens when we start talking, even when we get together jointly, is we want to fix the narrow piece that we have been involved in and don't want to pay attention to the broader issue.

Reminds me of a family that wants to buy a new car, looks at their revenue and can't figure out how they can buy it but they are

going to decide to do it, find a dealer who will let them have it for the lowest amount of money they can get, whether they own the car at the end of the day or not, and are ultimately headed toward a cliff. They will have neither the car nor the home nor anything else if they don't deal with it.

So let me ask you on one other issue, we haven't talked about this but I think it does have an impact on the overall piece, what the value of the U.S. dollar was in terms of the international markets, say in 2000. We had a strong dollar. All of a sudden we have seen that dollar go down in value dramatically. I don't know how much it has gone down but it has gone down substantially, whatever the dollar is today versus whatever it was in 2000, which is on the American consumer a tax any way you cut it. And tie that, if you will, to the questions or the issue as relates to investment, because when we own the debt, those dollars that the Federal Government was paying for the debt that was turned over in our economy today is turned over in the economies of other countries so we are sending the dollar overseas to increase their investment for the products we are going to buy and how that helps hit the wall sooner.

Mr. TRUMAN. I can't go to 2000, but from the peak of the dollar, which was in February of 2002 to today in real terms, adjusting for inflation rates on the broadest average that the Federal Reserve computes, the dollar is down 15 percent. It is down a lot more against the Euro and other currencies like that but it is down a lot less against the Chinese yuan. So the dollar is down 15 percent.

The second question: is that a tax on American consumers? The answer to that question is yes. But it is probably in the category of an inevitable tax on American consumers in the sort of death and taxes type of thing because you need to have a lower dollar in order to stimulate us to import less and for the rest of the world to buy more of our exports. And it is the one way that we close, one, not the only way that we close this current account deficit and stop having to send IOUs abroad, as I said to Mr. Scott, IOUs abroad that we have to pay interest on.

And we economists say there is a terms of trade loss in that because in fact we are now paying more for a given level of imports, sending more bushels of wheat abroad for every Lexus that we are importing. So that actually acts like a tax, but it is a necessary part of how the process works of correcting the current account deficit, and what this hearing is about is to make sure that as that process of squeezing that comes on, we actually can generate through the principle reason—we have the savings to replace the savings that we have been importing from abroad. And that is where these questions about raising taxes and going into entitlements and other mechanisms come into play.

Mr. WALKER. I would just say that arguably the way that we have felt the pain so far is decline in the dollar rather than an increase in long-term borrowing cost. We do have competition. The U.S. is still a global currency. We are not the only one in town anymore.

Mr. ETHERIDGE. Thank you.

Chairman SPRATT. Mr. Alexander.

Mr. ALEXANDER. Thank you, Mr. Chairman. General Walker, this sheet here is almost black but I believe it says major fiscal exposures of 50 trillion. What does that mean?

Mr. WALKER. What it means is it includes total explicit liabilities, which would include debt held by the public, military and civilian pensions, the unfunded obligations there, and Social Security and Medicare. It doesn't include everything. It doesn't include Medicaid, it doesn't include a variety of other things. So it is selected fiscal exposures. And the numbers down below with regard to Social Security and Medicare are the discounted present value dollar difference between dedicated revenues and likely expenditures based on the Trustees' best estimates.

Mr. ALEXANDER. The reason I ask is the members of the Blue Dog Coalition have signs posted outside most of their offices around and their numbers don't come anywhere close to this.

Mr. WALKER. Those signs are too low. Those signs are too low. That is part of our problem. We have got the wrong metrics. We are focusing on debt held by the public, all right, which is a small subset of this. It is basically a down payment of this number. And so we need to change how we keep score.

Another example is if you are heading for a cliff and you slow the car down to half speed by the time you hit the cliff that ain't going to get the job done. We need to change our metrics and measurements.

Mr. ALEXANDER. In another illustration earlier I think I saw two lines running parallel to each other, national savings versus individual savings. When an individual saves something, it is something tangible. Explain national savings.

Mr. GRAMLICH. National saving is the amount that we—that we reserve from production for growing investment, basically. And so when an individual saves, that money goes in a bank and can be used to finance corporate investment. If the government comes along and runs a deficit then a lot of the individual's money gets used up in paying for the deficit. And so the national saving would then go down. So that is why you have to worry about what the government is doing.

What we want to do is have both individuals save a lot and have the government not be detracting from the individual saving by mopping up their saving just to finance a deficit. You want to have that saving rooted all the way back to corporate investment.

Mr. ALEXANDER. Thank you. Thank you, Mr. Chairman.

Chairman SPRATT. Thank you, Mr. Alexander. Mr. McGovern is not here. Mr. Smith is not here. Mr. Doggett.

Mr. DOGGETT. Thank you very much. Thank you for the testimony you all have provided. Mr. Walker, if I understand your testimony, while we cannot rely exclusively on increased revenues to address these problems, there is no way we can solve these problems without a substantial increase in tax revenue over the long haul.

Mr. WALKER. Over the long haul I don't believe you are going to be able to solve the problem with taxes at 18.2 percent of GDP. I do think you want to keep it down as much as you can for the reasons I have articulated, but I don't think—politically I don't think you can solve the problem at 18.2 percent of GDP.

Mr. DOGGETT. You have indicated we have a shortfall of revenues today and we will have a much greater shortfall in the future if we continue on the present course.

Mr. WALKER. Correct.

Mr. DOGGETT. And that you have seen very few tax cuts that pay for themselves.

Mr. WALKER. That is the authoritative literature.

Mr. DOGGETT. Would you take a look back at page 5 of your charts where you talk about the baseline that you presented to this committee in January of 2001.

Mr. WALKER. I am familiar with it, yes.

Mr. DOGGETT. At that time did it appear that the spending and even entitlements were sustainable at the current revenue?

Mr. WALKER. Based upon the assumptions that existed at that point in time, some of which proved not to be valid, yes. I mean the assumption then, if you will note, there is no interest cost because the assumption then was we were going to pay off all the debt. We actually were going to have savings that we were going to invest.

Mr. DOGGETT. I remember the testimony to the Ways and Means where he was concerned we were going to pay off too much debt.

Mr. WALKER. So really some of the assumptions may have changed. The situation we find ourselves in today is largely the result of policy decisions that have been made in the last 6 years. Largely but not solely.

Mr. DOGGETT. That is right.

Mr. WALKER. For example, back in January of 2001 I testified about fiscal risk. The highest risk thing I said that Congress could do was increase entitlements. Guess what, that is what Congress did, called Medicare part D.

Mr. DOGGETT. The prescription drug program, and you have outlined the cost for that. And there has also been a reduction in revenues over that time, too, hasn't there?

Mr. WALKER. The combination of several things, changes in assumptions, number one; there has also been an increase in entitlements, there has been a significant increase in spending as compared to historical levels, not all of which is defense and homeland security, for a significant part is; and thirdly, tax cuts.

Mr. DOGGETT. You mentioned health care as perhaps the greatest public policy challenge that we face in the country today. Health care is responsible for a significant number of personal bankruptcies being taken across the country. As we look at how to address this looming crisis that you have described don't we also have to consider the crises that individual families are faced with health care and address those deficits in health care and education as well?

Mr. WALKER. Health care is the number one fiscal challenge for the Federal and State governments; number two, it is the number one competitiveness challenge for American business; and number three, it is a growing challenge for American families. Let me just tell you if there is one thing that can bankrupt America, it is health care. We need dramatic and fundamental reforms in phases over time and I am happy to talk about that some other time if you want.

Mr. DOGGETT. It could bankrupt our country or it could continue to bankrupt more and more families in the country if we don't find a way to address it.

Mr. WALKER. It would have an adverse affect on many players.

Mr. DOGGETT. I thank you for your testimony.

Chairman SPRATT. Mr. Moore.

Mr. MOORE. General Walker, I was at the White House with the Blue Dog leadership and the new Dem leadership about a month ago and had a chance to meet with the President, and when it was my turn the speak for 2 minutes I said, Mr. President, I have seven and a half grandchildren and we have mortgaged the future of our children and grandchildren. So I very much appreciate the slide with your three grandchildren because I think that is what all of us on this committee and Congress should be looking at because they are our future and we have done horrible things to their future. We need to change the way we are doing business. And I said to the President this should not be about Democrats and Republicans, we are all in this together as are future generations in our country.

I mentioned Blue Dogs. What should be the number instead of \$8.9 trillion national debt, what should be the number on the Blue Dog sign right now?

Mr. WALKER. \$440,000 per household.

Mr. MOORE. What does that come to in terms of trillions of dollars?

Mr. WALKER. \$50 trillion.

Mr. MOORE. Just in round numbers, right?

Mr. WALKER. In round numbers. That is big enough. We can round off at \$50 trillion.

Mr. MOORE. I understand, I really truly do understand, and I mentioned this shouldn't be partisan at all and I have heard from the other side and I am not trying to point fingers here but it gets frustrating when you hear that tax cuts kind of pay for themselves, and we have heard some difference this morning, and I understand we need to look at the whole big picture here if we are really going to make a difference here. It is about entitlements certainly. That is the big one that you have identified and others have identified. It is about spending, and we have got to look at that, and we have also got to look at tax cuts because I believe all tax cuts aren't created equal and they don't all pay for themselves. Some do, but some don't.

But what—what change in metrics, if any, I mean do you have any suggestions, and I heard you mention too that health care is the big, the big thing in the picture out here. Can you give us just—I know you don't have time to go into a lot of detail. I have got 3 minutes left. Can you give us just a summary of some of the ideas you have for reforming health care to make it better for us in the future?

Mr. WALKER. Well, first, I think you need to reconsider the Part D benefit.

Mr. MOORE. Yes, sir.

Mr. WALKER. Number two, we need to move the national practice standards, which would help us to control cost, improve consistency and reduce litigation.

Number three, we need to expand case management approaches within the Federal healthcare programs.

I mean, those are just a few examples, but since this is the Budget Committee, let me suggest that some of the things that need to be considered—we need to go back to PAYGO rules on both sides of the ledger. We need discretionary spending caps. We need mandatory reconsideration triggers when certain mandatory spending programs get to a certain size of the budget. We need to have more transparency and mandatory reconsideration triggers on tax preferences and tax expenditures as well. And whether you have a commission or not, you have got to have better transparency and strong budget controls in place to make sure you don't slip back and undo the good things that ultimately, hopefully, will get done.

Mr. MOORE. Well, I will pledge to the two members of the minority now that are on the other side here that are here that I really appreciate what you all have said. I have had private conversations with the ranking member about some of these items; and I, again, just hope we can come together and put aside some of the rhetoric and really work together to address some of these. Because that is what needs to happen not for us but for the American people and our country in the future.

One more question that is kind of a tag-along, I guess, is China right now, I understand, holds over half a trillion dollars, over \$500 billion of our debt. What would be—and I understand—I have read some of the materials that have been provided that say it is probably not going to happen. What would be the result, though, if China and some others who hold our debt decided they didn't want to hold our debt anymore? What would be the impact on our country?

Mr. TRUMAN. Going on the principle of comparative advantage, I think the first question is, if they sell treasuries and they buy equities, right, in the United States, the answer is nothing. Maybe the price of the treasuries goes down and the price of equities goes up.

Mr. MOORE. My question is, if they decide they didn't want to be involved—

Mr. TRUMAN. If they sell their holdings and they buy Euro dollars, Euro assets, denomination in Euros or yen or whatever you want to think in, then what you have is a—you could have, as you said, as you stipulated, not likely—these are sophisticated financial people, they don't want to shoot themselves in the foot—but you could have, if there was a widespread tendency for foreigners—or domestic residents, for that matter—to say, I have too much dollar assets because the United States government—people and government can't get their hands around the problems that Mr. Walker—General Walker—described, then you could have a sharp fall in the dollar, and that surely would shrink the current account deficit, and it surely would reduce the availability of savings from abroad, and that surely would put interest rates up, and whether our friends at the Federal Reserve could manage that without a recession is something you could bet on. I mean, one would hope so, but, at a minimum, you would have—as we did in the late 1980s, you would have sharply lower growth for a sustained period of time.

Mr. MOORE. Thank you.

One last comment, I just want to thank you for the good work you are doing in educating the American people and the Congress about what all this means to the future of our country. Thank you.

Chairman SPRATT. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. I thank the witnesses.

Dr. Gramlich, on the second page of your testimony, you say there has been speculation that bondholders would insist on higher long-term bond rates as deficit grows, but this hasn't really happened. Long-term rates are well behaved right now, and most reasonable forecasts expect them to remain so in the near future. We could worry that high deficits will cause high interest rates, but that would be crying wolf.

I am not crying wolf, but I fear the wolf. I do. And one of the reasons that I do is inherent in General Walker's testimony. I look at his graph on page 4. If I read it correctly, he says that under the most likely policy scenario that we are presently on, by 2010 we would be running a deficit of 4 percent of GDP, give or take; by 2015, it would be about 5 percent of GDP, give or take, trending up to 7 percent in 2020 and 10 percent in 2025.

Here is my question for all three on the panel: If General Walker's assumptions are correct and that is the path that we are on, do you think that we would reach a point where the wolf would visit the door and we would be punished in terms of higher interest rates, number one.

And, number two, if that is a scenario that we should be concerned about, what level of remedy do we need to achieve now to forestall or postpone that? In other words, how much deficit reduction in the short run is enough to mitigate the probability we would face that wolf at the door?

Dr. Gramlich, do you want to—

Mr. GRAMLICH. Yes, Congressman. I brought up the wolf, so I probably ought to deal with it.

I think what you are seeing—this is the conundrum. You know, given all these things—I mean, the international financial traders have seen David's charts. They know these numbers, but yet they are still not charging very high interest rates, and it is puzzling. I think the reason is, to be honest, that there is still a reservoir of faith in the American economy, in American politicians that, by the time this happens, the problem will be fixed. So, in some sense, the committee—there is almost nobody left here, but the committee could view this as a challenge—I mean, that you want to prove the bond traders right.

Mr. ANDREWS. My question is, what do we need to do to retain that faith?

Mr. GRAMLICH. I would say, put the deficit on a sustainable path. I mean, if you had the—I would prefer that the deficit be zero. I mean, that would be my heart of hearts. But there is a policy short of that where the debt-to-GDP ratio over time does not rise. It might be tantamount to deficits of 1 or 2 percent continuing, I mean, without the explosion that you see in the charts there. If that were the case, I think, you know, the bond traders would be okay with it. What I think they don't like is the unsustainability.

Mr. ANDREWS. Right.

General, what do you think?

Mr. WALKER. I think you need to address the biggest deficit that America has, which is not budget, which is not balance of payments, which is not savings, it is leadership. All right? That is the biggest deficit we have.

My view—I will come back to what I said before. If you improve transparency, if you enact meaningful budget controls and if you can achieve Social Security reform, round one of healthcare reform and round one of tax reform, that will go a long way towards helping to avert a potential crisis, and then we are going to have to re-engineer and reprioritize government. It is going to take 20 years.

Mr. ANDREWS. Do you think there is a quantitative manifestation of those goals, that either is percentage of debt to GDP or size of the deficit?

Mr. WALKER. I don't know that there is specific metric on that. I can just tell you right now that I think people are counting on Congress ultimately doing something and the President ultimately doing something, and I think it will by the way. We just need to do it sooner rather than later.

Mr. ANDREWS. I certainly agree with that.

Dr. Truman?

Mr. TRUMAN. On the first part of your question if we had that scenario, would the wolf bark at some point down the line? I think yes, but I can't tell you when. It could be as early as 2 years from now, within the next 2 years or it could be another decade—but I think it is unsustainable; and, ultimately, that will read into everybody's desire to hold claims on us.

The question of how much of a fix, I think—my view, and as I said in my testimony or as we said in our testimony, I think there is a sort of short-term objective, which might be phrased in terms of a surplus by the end of the deficit, preferably an on-budget surplus, so not on the unified basis.

Mr. ANDREWS. You mean by the end of the decade?

Mr. TRUMAN. The decade. Excuse me. I misspoke. Thank you for correcting me. By the end of the decade, preferably an on-budget surplus, because the off-budget surplus, as has been described, will go away anyhow. So you need to get yourself ready for that.

The more sophisticated way of doing it would be to sort of set some longer-term sort of constraints, maybe buttressed by David Walker's triggers to sort of, when you go off the track, you are forced to go back and reconsider things. That would be a sensible way of forcing yourself to re-examine these kinds of issues.

I am, however, tempted—maybe because I spent too many times in this hearing room sitting back there, rather than up here—to quote the two chairmen—two of the four chairmen of the Federal Reserve I worked for, Paul Volcker and Alan Greenspan, who, faced with similar circumstances, each said to a Budget Committee—I am not sure whether it was this one or whether it was your counterpart in the Senate—I don't lie awake worrying that you will do too much.

Mr. ANDREWS. Thank you very much, gentlemen.

Chairman SPRATT. Thank you all.

Could I put two questions to you quickly for Rosa DeLauro? She had to leave and go to a leadership meeting. And we will take a

quick answer so Dr. Gramlich can get out of here, and particularly by 12:30.

We face serious challenges in the energy sector, college tuition, healthcare cost, including some of the highest prescription drug prices in the world; and I, Rosa DeLauro, want to ask a simple question: How is the deficit, the cost of servicing the debt, impacting our ability to address these issues?

Mr. WALKER. The largest item of waste in the Federal budget arguably is interest on the Federal debt. It is the fastest-growing line-item in the Federal budget; and, therefore, it serves to squeeze out the ability of the government to do other things at a given level of taxation.

We have a number of sustainability challenges in America. Today, we have only talked about the fiscal one. I could give you 8 or 10 other ones.

Mr. GRAMLICH. Just on that issue, it is always possible to go through the budget and find this good thing and this good thing and this good thing. Each of these good things should be evaluated on their face, but there is an overall test, and, as I said in my testimony, if you really want all these good things, well, we just have to pay for them.

Mr. TRUMAN. I agree. I don't have anything to add, in the interest of time.

Chairman SPRATT. Final question. Rosa DeLauro. Together tax cuts and spending increases for security programs account for 84 percent of the increases in debt racked up by Congress and the President over this recent period. At the same time, the administration insists in making the tax cuts of 2001 and 2003 permanent and, on the spending side, there is not much inclination to cut discretionary spending beyond the levels we have already cut. Given the long-range deficits that we face, what do you think is the wisdom of this proposal?

I think by that she means what is the wisdom of the proposal to make permanent the 2001 and 2003 tax cuts?

Mr. WALKER. I think you need PAYGO rules on both sides of the ledger. If you want to make them permanent, you pay for them. And I also would say that there is waste in defense and homeland security, billions and billions and billions a year. Don't assume there is not, because there is.

Chairman SPRATT. Dr. Gramlich, do you agree?

Mr. GRAMLICH. Fine, yes.

Chairman SPRATT. Dr. Truman?

Mr. TRUMAN. I think there is one qualification, right, that seems to me should be made, and that is that putting PAYGO into place at a time when you are dealing with the deficit that is already there, right, especially if you use some of the larger numbers that David Walker has in his little chart, that doesn't really help you because you actually—it helps you, it helps things from getting worse, but it doesn't help you dig out of the hole that you have already created.

And one can argue about where the tax take is going to have to be over the next 25 years on average, and I think I agree with—as a projection, as a forecast, I agree with David in this, that 18 percent is going to be higher.

I also agree that going to 40 percent will not sustain the U.S. economy. And I suspect it will be lower, the bottom end of that range, rather than the top of that range.

These things, again, have to add up, and I think the thrust of Congresswoman DeLauro's question is that, in a way—and this was the thrust of David Walker's answer earlier, put another way—is you now have to pay for some of the things that you have been doing over the last 5 years, both in terms of actual expenditures and in terms of commitments to future expenditures. And that I think is a really tough issue that the Congress has to address.

Mr. WALKER. Just to quickly reinforce, PAYGO is not enough. We need discretionary spending caps, mandatory spending reconsideration triggers. We need to disclose the discounted present value dollar cost of major tax and spending dollar proposals in present value terms. We need to do a lot more, because we are in rougher shape today, and the tsunami is closer to hitting our shores.

Chairman SPRATT. The problem with discretionary caps is that half or more of discretionary is defense, and there are substantial variables to deal with that due to the cost of the war which comes to us in the form of supplemental.

But, quickly, I turn to Mr. Ryan for a final question.

Mr. RYAN. I know, Dr. Gramlich, you have to get going, so I am going to ask David a question.

First, just to kind of correct the record, we don't think that all tax cuts pay for themselves. No one says that on our side of the aisle. Just the point is that not all tax cuts are the same. Some produce more growth than others, some produce more jobs and realizations and economic growth than others, some may partially offset each other. So that is just a point for the record.

My question for you—well, and one more point. It may be easier to just reform the whole Tax Code than get rid of the AMT and make the tax cuts permanent. We have got a whole tax tidal wave hitting us at the end of this decade where we will have 25 million people paying the AMT and we will have something close to a \$2 trillion tax increase when these things expire which would wreak havoc on our economy. So maybe the way out of this thing is to fundamentally reform our Tax Code and do it based on a consumption and one that is internationally competitive.

I just throw that out there. I am a member of Ways and Means, and we spend a lot of our time thinking about that.

David, the quick question I have is this: You mentioned doing benefit changes on Social Security to get solvency, but then you threw sort of—I guess I will just paraphrase it—add-on accounts on top. Clawback accounts can be a part of reaching solvency; add-on accounts don't. But you can have a—component add-on accounts that do ultimately contribute to solvency. I hate using the word "clawback," but that is the feature that some—and I have been more of a clawback guy. Are you proposing that we do mandatory add-on accounts with some kind of a solvency gaining feature to them or just total free add-ons?

Mr. WALKER. A possible way forward—I am not saying “the” possible way forward—would be as follows: Increase the normal retirement age gradually and index it to life expectancy.

Mr. RYAN. Longevity indexing?

Mr. WALKER. Right, change the replacement rates to reduce the replacement rates for middle- and upper-income individuals.

Mr. RYAN. Indexing factors?

Mr. WALKER. That is one way to do it, the indexing factors or whatever.

Thirdly, strengthen the minimum benefit for the poor.

Fourth, you can do that and a few other things without more revenues. You may politically have to consider an increase in the taxable wage base. You don’t—politically, you may have to do it. You can make the numbers work without doing that.

And then, on top of a restructured, solvent, sustainable and secure defined benefit program, consider mandatory individual savings on top of that would go—that would be real savings into a real trust fund with a limited investment option like the Federal Thrift Savings Plan on top of that.

Now that Congress is poised to increase the minimum wage, the people that would be the most pressed by that would be those persons—and history has shown that when you end up saving on a payroll deduction basis and it is automatic and people don’t touch the money, you actually can get real savings increases.

Mr. RYAN. Okay. So, just to paraphrase, progressive indexing plus longevity indexing gets you solvency, basically, right there. Correct me if I am wrong. And then you are saying, throw some add-on accounts on top that are mandatory add-on accounts that are pre-taxed, that are carved out from your current tax base?

Mr. WALKER. It is mandatory. I don’t know why you would make it pre-taxed.

The question is, what are you going to do with the build-up? If it is mandatory, it is mandatory. Why give a tax preference? They have to do it. It is their money.

I will also argue that is not a tax increase, because it is their money, and they will have an irrevocable right to it from day one. It will go to a trust fund in their name, and they will be able to control the investment of it, pre-retirement death benefit and funding mechanism for long-term care, et cetera, et cetera.

Mr. RYAN. And the money goes to you free and clear at the end when you retire?

Mr. GRAMLICH. Yes. Congressman, I think a lot of us like these add-on accounts, but it is fundamentally about saving, and it is not about solvency at the system. It is a separate issue.

Mr. RYAN. Exactly. Some people who propose add-ons add a solvency component to it. I just wanted to see if that is what he was saying or not.

Mr. WALKER. Solvency sustainability is outside of the individual accounts. I am talking primarily for savings, pre-retirement, death benefit, et cetera, et cetera, having this supplemental individual account.

Mr. RYAN. Thanks for clearing it up.

Chairman SPRATT. Thank you very much indeed for your valuable contribution, understanding the problem we are faced with.

Mr. Scott.

Mr. SCOTT. The ranking member asked about tax cuts having a different effect. Could you give us some information on which tax cuts actually do stimulate the economy more than others? Is there information on that for the record?

Mr. WALKER. We will coordinate with CBO and others and see what we can do here.

Chairman SPRATT. I ask unanimous consent that members who did not have the opportunity to put questions to our witnesses today be permitted to do so by submitting questions for the record. [The information follows:]

PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS,
1750 MASSACHUSETTS AVENUE, NW,
Washington, DC, February 15, 2007.

Mr. John M. Spratt, Jr.,
Chairman, Committee on the Budget, House of Representatives, Washington, DC.

DEAR CHAIRMAN SPRATT: Enclosed are my answers to Representative Kaptur's questions that you transmitted to me on February 8.

Again, I appreciated the opportunity of testifying before the committee on this important set of issues.

Sincerely,

EDWIN M. TRUMAN,
Senior Fellow.

RESPONSES TO QUESTIONS BY REPRESENTATIVE KAPTUR

1. *I understand that in the recent past nearly 90% of new public debt was purchased by foreigners. To your knowledge, is there any linkage between our trade deficit and this increased foreign holdings of US debt?*

Foreigners have purchased a very large proportion of the net increase in US Treasury debt outstanding in recent years. From December 2001 to November 2006, they purchased an estimated 85 percent. Over the immediately preceding 12 months, the share was 86 percent. There is no direct connection between our trade deficit and foreign purchases of US Treasury debt. In 2006 our deficit on goods and services rose \$46.9 billion (census basis) while foreign purchases of treasuries rose only \$5 billion. However, our large trade and current account deficits along with US capital outflows have as their counterpart inflows of foreign capital from abroad. During the first three quarters of 2006, the gross inflow of foreign capital to the United States was an annualized \$1,723 billion, \$1,543 billion excluding foreign direct investment in the United States. Foreign purchases of treasuries were only 14 percent of the \$1,543 billion in financial inflows. We require financing from abroad for our large trade and current account deficits. What is important is that foreigners buy some type of US assets not what type of assets they purchase.

2. *Why is it that foreign buyers are purchasing this [US Treasury] debt and not American buyers? Do American investors simply not have the resources, or do they consider American debt an unwise investment?*

As of the end of 2005, foreign holdings of US financial assets (excluding foreign direct investment) were an estimated \$10,828, of which \$1,994 billion or 18.4 percent was US Treasury debt. About 65 percent of that amount was foreign official holdings although that figure is probably somewhat understated. Thus, foreigners purchase a wide range of US financial assets, but they have a relative preference for US Treasury debt compared with US investors. There are many possible explanations for that relative preference, but the most likely is that US Treasury debt is liquid and the highest quality even though as a consequence its yield is lower than on other types of US financial assets. According to the Board of Governors of the Federal Reserve System, the personal sector (households, non-farm non-corporate business, and farm business) added \$1,977 billion to their financial assets (at an annual rate) over the first three quarters of 2006, increased holdings of US Treasury debt were about 3 percent of that total. As noted in my answer to the previous question, US Treasury debt was 14 percent of foreign purchases of US financial assets over the same period (at an annual rate). Thus, American investors have the resources to acquire financial assets and are doing so. However, they have a relative preference for higher yielding and less liquid assets than US Treasury debt.

Chairman SPRATT. Once again, thank you for your contribution to understanding the daunting and difficult problems we are faced with. Thank you very much for coming today.

[Whereupon, at 12:30 p.m., the committee was adjourned.]

